Overview for educational purposes only; it is not legal advice and may not be relied on as such.

I. **Introduction.** There are three basic principles to be followed in structuring the relationship between a charity exempt under Section 501(c)(3) (“Charity”) and a social welfare organization exempt under Section 501(c)(4) (“C4”), where Charity has been established for some time prior to the creation of C4 and will continue to be the dominant member of the tandem, and its public face. The three principles are:

- maximum feasible separation of Charity and C4, legally, financially, and operationally;
- avoidance of any subsidy by Charity of C4 operations; and
- no day-to-day control by Charity of C4, although Charity may exercise strategic control over C4.

These same three principles also apply where C4 is pre-existing and/or dominant, or where both entities are created at the same time. However, because Charity’s assets are the most restricted, it is hardest to follow these principles where Charity dominates.

These three principles are discussed in turn in Sections II through IV below. Section V analyzes the impact of adding a Section 527 political organization to the mix. Section VI contains some final reminders.

II. **Maximum feasible separation.** C4 should be a separate legal identity from Charity, which is most clearly established through separate incorporation and separate operations.

A. All corporate formalities should be scrupulously observed by each organization -- separate meetings of staff, board, committees; separate minutes of meetings; etc.

B. While completely overlapping boards of directors are not prohibited, we advise strongly against them, since in practice complete identity of boards often leads to
confusion about which board is acting at any point in time. In order to allow a disinterested majority of the board of each entity to approve transactions between the entities, while at the same time ensuring that each entity’s interests are protected and their separation is observed, we recommend at most a minority overlap between the two boards, counting not just directors, but also officers or employees of one entity serving as directors of the other. At the same time, to preclude mission drift and ensure the two entities stay aligned over time at a strategic level, we recommend one entity have the power to appoint and remove a majority of the board of the other, subject to the limit in the preceding sentence. This recommended structure will not work in every situation, and a variety of alternative control mechanisms or configurations are available beyond the scope of this overview.

C. Each organization should apply as appropriate for recognition of its tax-exempt status to IRS and state regulators.

D. Each organization must maintain its own full set of corporate, tax, and financial records.
   1. Each entity must have its own federal employer ID number.
   2. Each organization must have its own separate bank accounts, and funds should not be commingled or transferred without appropriate (and documented) reason.
   3. Bookkeeping and other corporate records should be independently maintained.

E. As soon as the scope of C4’s operations will support it economically, C4 should have its own paid staff of employees, even on a part-time basis, rather than using Charity administrative staff.

F. Funding sources and fundraising efforts should be distinct, although joint efforts are possible with careful planning.

G. When practical, C4 should establish its own accounts with vendors and be separately invoiced, for example, for printing, office supplies, etc.

H. The mailing address of C4 should be different from Charity’s, even if it is only a post office box which will be the only address shown on C4’s letterhead. C4 should not use Charity’s address.

I. The phone number for C4 should also be a separate line, and if possible, C4 should set up a separate account with the telephone company and be separately invoiced.
J. The two organizations should each have a distinct Internet presence: separate e-mail addresses, websites, and social media pages, although appropriate links may be made.

III. No charitable subsidy of non-charitable activities. Charity may not subsidize C4 operations (although C4 may subsidize Charity’s).

A. Charity may legally fund specific charitable projects conducted by C4, subject to Charity’s discretion and control. Charity should enter into a written grant agreement specifying how the funds will be used by C4, C4’s obligations to report on the use of the funds to Charity, and Charity’s remedies if C4 misuses the granted funds.

B. Charitable projects conducted by C4 with Charity’s grant support may include lobbying, but no political intervention in candidate campaigns. Charity may grant funds within its annual lobbying limits to C4 for such charitable lobbying.

C. Charity should not provide goods or services to C4 without receiving payment representing full fair market value in return. (C4 may provide goods or services to Charity at no charge, or at reduced rates.)

1. Where complete operational separation is not feasible, Charity may allow C4 to share its facilities and resources. This may include sharing staff for program, supervision and administration, bookkeeping, payroll, clerical work, lobbying and government relations, media and public relations, etc.

   a. Charity’s actual costs to provide facilities and resources should be charged directly to C4. Assuming Charity’s costs reflect typical commercial rates or result from arm’s-length bargaining between Charity and unrelated vendors, Charity’s costs will represent the full fair market value of those facilities and resources, and therefore C4’s reimbursement of those costs to Charity will be devoid of any subsidy. C4’s share may be determined on any reasonable basis, typically the share of employee hours spent on C4’s activities. (If the arrangement is not properly structured as a reimbursement, such as where Charity charges C4 more than its cost, Charity may have unrelated business taxable income.)

   b. Charity staff working on C4 matters will generally need to keep timesheets, which can then be used to determine the percentage of each Charity employee’s time, during each pay period, devoted to C4 work. That percentage of the employee’s salary should be charged to C4, plus a factor covering all employee benefits.

   c. Using a reasonable allocation method (such as employee time spent working on C4 matters versus C3 matters), a proportionate amount
of Charity’s overhead, including rent, utilities, support staff, etc., should also be charged to C4.

d. Where it is practical to separately meter C4’s use of Charity resources (e.g., phone calls, photocopying), records should be kept and Charity should bill C4 accordingly, instead of capturing them in the allocation of overhead.

2. To avoid Charity’s advancing funds or credit on C4’s behalf, C4 may deposit the estimated value of such shared resources for the first month of operations with Charity. As reimbursement charges are made against the deposit, C4 would replenish the deposit each month. Alternatively, amounts due to Charity from C4 should bear interest at applicable market rates.

3. The resource sharing arrangements should be formally documented in an agreement between Charity and C4.

D. If office space is shared, occupancy costs may be allocated as part of overhead, or Charity and C4 may enter into a commercially reasonable lease or sublease. (The rental may be below market only if it is C4 leasing or subleasing to Charity.)

E. If Charity wishes to extend coverage under its directors and officers liability insurance policy to C4, it may do so, provided C4 pays for such coverage. Even if the insurer adds the C4’s directors and officers to Charity’s policy at no additional cost, C4 should pay Charity for some proportion of the premiums, allocated on some reasonable basis such as the relative size of the two organizations’ annual budgets.

IV. No day-to-day control, whether actual or apparent. Charity may exercise strategic control over C4, but should not direct or control the day-to-day activities of C4, or foster the appearance of seamlessness between the two entities.

A. To maintain the integrity of the separate incorporation of C4, and minimize Charity’s liability exposure, Charity should not become involved in the day-to-day management of C4’s affairs. Charity’s board and officers should never direct C4’s board or staff to take any action, or vice versa. Lines of authority, accountability, and responsibility should be separate, clearly understood, and well-documented.

B. Charity and C4 may communicate and coordinate at the strategic level, so long as it is clear that they are distinct entities, each with its own agenda, furthering its own corporate purposes, in such cooperation. This communication and coordination typically takes the form of overlapping boards of directors, as described above. The agenda and purposes of the two entities may be closely aligned or dovetailed, but should remain distinct.

C. In addition to carefully observing the legal separation of the two entities, the greater their operational separation, the lower the risk of the two being collapsed (whether
by a court or the IRS) into one entity, resulting in loss of Charity’s tax exempt status. However, complete operational separation is neither practical nor required. Especially during its start-up phase, or where C4’s operations are on a much smaller scale, complete separation of operations is not economically feasible. A greater degree of operational separation may become realistic over time, as C4’s programs grow larger and more established. The question of maximum feasible separation in operations should be reviewed at least every few years by both boards, and adjustments made as possible.

D. All agreements between C4 and Charity should clearly state that they are not management contracts. The C4 board is not delegating management of its affairs to Charity (or vice versa). Rather, the C4 is contracting with Charity to share the time of certain staff members, who will carry out administrative or program tasks assigned by the C4, under the direction and control of the C4 board.

E. Charity and C4 should take care to ensure that they are not confused with each other by their constituencies or the public.

1. Charity and C4 should have separate letterhead; shared staff should have separate business cards; and shared staff should always be careful to introduce themselves using the right one, or otherwise clarify for which entity they are acting or speaking in public situations.

2. Both organizations may need to take steps to clarify, where appropriate, for the news media and others, that Charity and C4 are separate organizations. This may require that Charity monitor media coverage and, when confusion is apparent, send letters to media outlets to make the distinction clear.

3. Board, staff and volunteers of both organizations should be educated about the distinction, and that education should be documented. We suggest using a handout, to be signed by each employee and volunteer of either organization who works on affairs of the other or who deals with the public, and kept on file by each organization. The handout would explain the distinction between the two organizations and emphasize that no one is acting as an agent of Charity while working for C4.

4. Organizational brochures and websites of each should explain the relationship to the other if there is any risk of confusion.

IV. How do these rules change if C4 decides to form a Section 527(f)(3) separate segregated fund (“SSF”) to engage in candidate political intervention activities?

Briefly:

A. Rules found in the Internal Revenue Code and the Regulations thereunder must be followed concerning how funds may flow from C4 to SSF (e.g., the funds
must be earmarked for SSF by the donor and promptly transfer by C4 to SSF) and what kind of support C4 can provide SSF (e.g., administration and fundraising) without incurring the Section 527(f) tax.

B. Any applicable federal, state, or local election laws (which may concern who may be solicited to donate to SSF, and how often, or reporting obligations on SSF to the Federal Election Commission or state or local election regulators, for example) must be followed, in addition to federal tax law relating to exempt organizations.

C. Otherwise, the rules about separation between Charity and C4 remain the same, regardless of SSF’s existence. However, as soon as C4 engages in electioneering activity, itself directly or through SSF, the compliance stakes are higher, since now Charity’s tax-exempt status is at risk, not just the tax on excess lobbying. Charity is absolutely prohibited by Section 501(c)(3) from participating or intervening in candidate elections for public office, which is the primary purpose of SSF, so it is critical that the separation between Charity and C4 is clear.

D. To avoid the risk, Charity may absolutely prohibit C4 from engaging in any electioneering, directly or through SSF, in C4’s bylaws or by contract. Or Charity may demand that a higher level of separation between Charity and C4 must be in place before any electioneering is permitted or SSF is formed.

E. Although the IRS has indicated some flexibility here, we advise that the name of SSF should not incorporate the name of Charity, except where C4’s name incorporates Charity’s name, and applicable election law requires SSF to include C4’s name, as its sponsor in SSF’s name (this situation is relatively common).

F. Use extreme care in any joint fundraising if both Charity and SSF are involved – Charity’s goodwill or other assets may not be used in any way to promote or benefit SSF. Also be sure any such fundraising complies with all applicable election or campaign finance and disclosure laws, which may restrict amounts and sources of fundraising by SSF.

G. Note that C4 may actually need multiple SSFs (for example, for state vs. federal elections), and also may want to establish some non-527 PAC accounts to track fundraising and expenses associated with activities that are NOT candidate electioneering within Section 527, but ARE subject to regulation and reporting under state or local election laws, such as ballot measure activities.

VI. **Final note.** The purpose of these rules is to maximize the likelihood that courts and regulators like the IRS will respect the separate existence of Charity and C4, protecting the assets of each from the liabilities of the other, and protecting the tax status of Charity from activities that could endanger it conducted by C4. These are guiding principles, not absolutes; the specific arrangements must, of course, be tailored to the realities of the
situation as well as legal requirements. The question of whether the separation of the two entities will be respected, whether for tax purposes or general liability concerns, is a multi-factor test; if in your situation, you must do poorly on some measures, try to do even better on the others.
ELECTION-YEAR ISSUES FOR CHARITIES
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I. Coverage. This outline is for organizations exempt under Section 501(c)(3), and does not address organizations exempt under other subsections of 501(c). This outline does not cover the creation or operation of complex tandem or tri-partite multi-organization entities that have 501(c)(3), 501(c)(4-5-6), and/or 527 component parts. This outline also does not cover legislative lobbying by public charities, even though some types of legislation (ballot measures, referenda, initiatives) are voted on in elections, at the same time as voting for candidates. Finally, this outline does not address federal, state, or local elections or campaign finance laws, which are beyond the scope of this outline, but which may significantly affect or prohibit the conduct of activities acceptable for a 501(c)(3) organization under federal tax law as described in this outline.

II. Basics of the electioneering prohibition. Section 501(c)(3) of the Internal Revenue Code ("IRC") requires that, to qualify as tax-exempt thereunder, a charity may “not participate in, or intervene in (including publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.”

A. This prohibits endorsing candidates or making contributions to candidates’ campaigns.

B. The IRS will consider any and all facts and circumstances it deems relevant in determining whether a violation has occurred.

C. Applying the facts-and-circumstances test, the IRS has interpreted Section 501(c)(3) to permit a variety of election-related activities if conducted in a nonpartisan manner. In this context, an activity is “nonpartisan” if it is not biased for or against any candidates and is not structured to help or hurt the chances for election of any candidate or group of candidates. However, Section 501(c)(3) prohibits charities from engaging in educational activities or voter registration efforts in a biased or partisan manner that benefits a particular candidate or group of candidates. In this context, an activity is “partisan” if it encourages voters to support

1 “Charity” as used in this document refers to an organization that is exempt from Federal income taxes under Section 501(c)(3).
or oppose a particular candidate or group of candidates, whether or not the favored candidates are associated with one political party or not.

D. There is no comprehensive statutory or regulatory guidance on what nonpartisan means, or how to conduct particular activities in a nonpartisan manner. Instead, over the years, the IRS has issued guidance addressing specific fact situations, many of which are reviewed below.² If your exact fact situation has not been addressed by the IRS or the courts, you may reason by analogy, but must proceed at your own risk, unless you have the time and money to seek a private letter ruling from the IRS.

E. If a charity does violate the prohibition on partisan political activity, the IRS may revoke its Section 501(c)(3) status, and/or impose excise taxes based on the amount the charity spent on the partisan activity. Such excise taxes can be imposed on both the charity and on the managers who approved the expenditures.³

F. Particularly after revelations in 2013 that the IRS improperly targeted Tea Party groups’ exemption applications, this area of law continues to evolve, so it is important to remain attentive to additional guidance from the IRS and the courts.

III. Voter education about the candidates

A. Publishing or distributing voter guides from questionnaires sent to candidates. A charity may publish candidates’ responses to a questionnaire if the safe harbor rules in Revenue Ruling⁴ 78-248 (Situations 2 and 3) are followed. These generally require that the charity publish the responses of all candidates in a particular race, cover a wide variety of issues selected by the charity based on their importance and interest to the electorate as a whole, and avoid any evidence (in the wording of questions, or in the content or format of the voter guide) of any bias for or against any candidate or group of candidates. Note that these rules apply whether the charity prepares the voter guides itself, or distributes guides prepared by others.

While not binding precedent, a charity should also be able to follow the terms of the Christian Coalition’s settlement with the IRS concerning its 501(c)(4) status, made public after the IRS approved its exemption application in September 2005. The Christian Coalition’s principal dispute with the IRS concerned whether its voter guides could be distributed by 501(c)(3) churches without violating the electioneering prohibition, and the exemption application clarifies details not

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² An excellent survey resource to begin any research in this area is the article by Judith Kindell and John Reilly entitled “Election Year Issues” in the IRS’s FY 2002 Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook. However, two important rulings discussed in this memo—Rev. Rul. 2004-6 and Rev. Rul. 2007-41—were issued after that survey article was written.

³ Excise taxes for political expenditures can be imposed under Section 4955 for either public charities or private foundations; in addition, Section 4945 taxes can be imposed on political expenditures of private foundations.

⁴ Revenue Rulings are issued by the IRS, and may be cited as authoritative as to the IRS’s position described in the Revenue Ruling.

B. **Ranking or rating candidates.** A charity may not publish rankings or ratings of candidates, even if the ratings were determined without regard to political affiliation and resulted from a neutral and unbiased process. See *Association of the Bar of the City of New York v. Commissioner*, 858 F.2d 876 (2d Cir. 1988), *cert. denied*, 490 U.S. 1030 (1989), and LTR\(^5\) 9619596.

C. **Candidate forums and debates.** A charity may host or sponsor a candidates’ debate if the framework described in Revenue Ruling 86-95 is followed, requiring that the charity invite all legally-qualified candidates; that questions cover a broad range of issues prepared and presented by a nonpartisan, independent panel of experts such as representatives of the media or educational organizations, or community leaders; that each candidate receive an equal opportunity to present views; and that there is a moderator whose function is solely to assure that ground rules are followed, and who states at the beginning and the end of the proceedings that the views expressed by candidates are their own, and sponsorship of the forum is not intended as an endorsement of any candidate by the sponsoring organization. It is not clear whether a candidate’s refusal to participate after being invited prevents the charity from holding the debate. In addition, in later (nonbinding) statements, the IRS has indicated that fewer than all candidates may be invited if reasonable, objective criteria were consistently and non-arbitrarily applied to decide whom to invite, especially if inviting all candidates is impractical. See, for example, TAM\(^5\) 9635003.

D. **Scheduled campaign appearances at charity events.** A charity may invite candidates to appear in their capacity as candidates, as a means of educating the public or the charity’s members about the candidates’ positions on issues. See Revenue Ruling 2007-41, Situations 7, 8, and 9. Such appearances should generally follow the guidance for candidate debates, discussed above. If the candidates are each invited to appear alone at one in a series of events, all candidates in a race who meet objective criteria must be invited, and the opportunity given to each must be roughly equivalent considering the anticipated audience, amount of time, time of day, setting, etc. (Although permitted by tax law, such appearances could violate federal, state, or local election laws in some circumstances, so consult appropriate legal counsel before proceeding.) (If a public figure appears in a non-candidate capacity, such as a speaker at a charity fundraiser or event, these “equal time” requirements do not apply; this is discussed below at Section VII. D.)

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\(^5\) Private letter rulings, cited here as PLR’s, and technical advice memoranda, cited here as TAM’s, are public documents describing the IRS’ application of the law to a specific set of facts as presented by a taxpayer. They may not be cited as precedential by any other taxpayer, although they do provide insight as to how the IRS might analyze a similar situation if presented with it.
E. **Unscheduled campaign appearances at public charity events.** Candidates may appear without an invitation at charity events that are open to the public. If that occurs, the charity should not refer to the individual’s candidacy or the election, or allow its event to take on a partisan character. It may, however, recognize the presence of a public figure if this is a customary practice of the charity, as long as no reference is made to his or her candidacy. See Revenue Ruling 2007-41, Situation 10.

IV. **Voter registration and GOTV.**

A. **Nonpartisan registration and GOTV.** A charity may conduct voter registration and GOTV drives if done in a strictly nonpartisan manner, both as to content of message and targeting of distribution. See Revenue Ruling 2007-41, Situations 1 and 2. The charity may not refuse to register voters based on how they expect to vote, nor may it use particular issues to encourage registration or voting by those only on one side of those issues. The charity can refer to a specific issue as a reason to vote, so long as the charity is not, directly or indirectly, telling the voter which way to vote based on candidates’ positions on that issue. But polarizing “wedge” issues should be avoided in the context of a voter registration campaign, since this could be construed as an indirect way of telling people how to vote. Referring to a wide variety of unrelated issues that are not wedge issues as reasons to vote is a safer approach. Note that targeting those historically underrepresented in the democratic process (e.g., racial minorities), or an organization’s natural constituency (e.g., patients at a local drop-in clinic), will generally not, without more, convert a nonpartisan activity to a partisan one, even if the targeted group is statistically more likely to vote for candidates of one party than the other.

B. **Special rule for private foundations.** Generally, private foundations, as 501(c)(3)s, are subject to the same prohibition on electioneering as public charities, although in practice their concern focuses on what grantmaking, rather than what activities, are permitted. *With one exception*, a private foundation may fund any election-related activity that a public charity may conduct. The one stricter, special rule for private foundations is found in Section 4945(d)(1), which defines as a “taxable expenditure” “any amount paid or incurred by a private foundation . . . except as provided in subsection (f), . . . to carry on, directly or indirectly, any voter registration drive”. This prohibits a private foundation from funding voter registration activities of public charities unless the requirements of Section 4945(f) are satisfied. These include that the voter registration activity be conducted by a 501(c)(3) organization, on a nonpartisan basis, in at least five states, and over more than one election cycle. Grantees seeking such funding from private foundations can obtain an IRS ruling that their proposed voter registration activities satisfy Section 4945(f); otherwise, a private foundation should make the determination itself, or rely on the opinion of its legal counsel, before earmarking any grant for voter registration activities. Alternatively, in many circumstances a private foundation could make a general support grant to a
charity that conducts voter registration activities that do not comply with the requirements of Section 4945(f).

V. Influencing the candidates’ positions on issues.

A. **Lobbying candidates or parties.** A charity may generally send its pre-existing educational materials to candidates, campaigns, or political parties, unsolicited, in order to educate the candidates or parties about the charity and its views. The charity should address such materials to all candidates in a race. A charity may also seek to influence the candidates’ or parties’ positions on issues, through meetings or otherwise, again so long as such efforts are directed equally at all candidates or parties in an electoral race. A charity may respond to candidates’ inquiries about the charity’s positions on issues with available educational materials, but should not undertake any special work to respond, as that could be seen by the IRS as providing services to the campaign.

B. **Candidate pledges.** According to Revenue Ruling 76-456, asking a candidate to pledge or promise to support a charity’s position on an issue if elected is prohibited. The IRS assumes a charity would only seek such a pledge for the purpose of publicizing the candidates’ responses, casting candidates who agreed in a more favorable light, and those who refused in a less favorable one, thereby influencing their chances for election. This ban on seeking pledges from candidates is, in practice, a trap for the unwary, since charities may want to do this without intending to influence elections.

VI. Issue advocacy during an election campaign.

A. **Issues advocacy that “functions as political campaign intervention.”** A charity may not use a supposed issue ad to convey veiled messages in support of or opposition to favored candidates or parties. To determine whether a communication “functions as political campaign intervention,” the IRS looks at all the facts and circumstances, including:

- Whether the communication identifies one or more candidate for public office;
- Whether the communication expresses approval or disapproval for one or more candidates’ positions and/or actions;
- Whether the communication is delivered close in time to the election;
- Whether the issue addressed in the communication has been raised as an issue distinguishing candidates for a given office;
- Whether the communication targets voters in a particular election;
- Whether the communication is part of an ongoing series of communications by the organization on the same issue that are made independent of the timing of any election; and

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Whether the timing of the communication and identification of the candidate are related to a non-electoral event such as a scheduled vote on specific legislation by an officeholder who also happens to be a candidate for public office.

Revenue Ruling 2007-41 states that a “communication is particularly at risk of political campaign intervention if it makes a reference to candidates or voting in a specific upcoming election. Nevertheless, the communication must still be considered in context before arriving at any conclusions.”

Some instances of issues advocacy that “functions as political campaign intervention” are discussed below.

B. **Raising the profile of wedge issues.** Where positions on narrow issues coincide with the well-known fault lines between candidates (often called “wedge issues,” such as abortion rights, gun control, the Iraq war, universal health care, or tax cuts versus deficit reduction), the IRS has difficulty fixing the boundaries for acceptable Section 501(c)(3) activity. The IRS may find that a charity implicitly endorsed a candidate by promoting a particular position on an issue which that candidate is known to espouse and then mentioning the upcoming elections and the importance of voting, or by using certain phrases (e.g., progressive, right-wing, environmentalist) as code words for candidates. See Revenue Ruling 2007-41, Situation 16; compare PLR 8936002 and PLR 9117001.

C. **Grassroots advocacy mentioning a candidate.** A charity may engage in grassroots lobbying of legislators or executive branch officials during campaign season; however, public communications that mention an official who is a candidate for election to public office present a particular risk of campaign intervention. The IRS has issued two Revenue Rulings that provide some guidance on when issue advocacy crosses the line into political campaign intervention. In Revenue Ruling 2007-41, the IRS applied the above factors to two hypothetical charity issue ad campaigns, indicating one campaign was acceptable 501(c)(3) activity while the other crossed the line. See Revenue Ruling 2007-41, Situations 14 and 15.

In addition, in Revenue Ruling 2004-6, the IRS addressed issue advocacy communications of Section 501(c)(4), (5), and (6) organizations that may mention a candidate and may appear shortly before an election. (Section 501(c)(4), (5) and (6) organizations may be subject to tax under Section 527(f) on their expenditures for such activities.) Revenue Ruling 2004-6 lays out a list of factors, good and bad, that apply to determine whether a given communication is potentially taxable, and then applies the factors to six hypothetical fact situations.

Caution: Political intervention by a Section 501(c)(4), (5), or (6) organization must not be its primary activity if it is to qualify as tax-exempt. The IRS has not stated whether Revenue Ruling 2007-41 or 2004-6 applies for purposes of the primary
purpose test. It is uncertain whether the two Rulings are intended by the IRS to reach the same result in every case. We recommend consultation with legal counsel on any borderline communications, especially if large expenditures are involved.

1. **Factors indicating political activity ("bad" factors).**

   - The communication identifies a candidate for public office.
   - The timing of the communication coincides with an electoral campaign.
   - The communication targets voters in a particular election.
   - The communication identifies that candidate’s position on the public policy issue that is the subject of the communication.
   - The position of the candidate on the public policy issue has been raised as distinguishing the candidate from others in the campaign, either in the communication itself or in other public communications.
   - The communication is not part of an ongoing series of substantially similar advocacy communications by the organization on the same issue.

2. **Factors indicating no political activity ("good" factors).**

   - The absence of any one or more of the six negative factors above.
   - The communication identifies specific legislation, or a specific event outside the control of the organization that the organization hopes to influence.
   - The timing of the communication coincides with a specific event outside the control of the organization that the organization hopes to influence, such as a legislative vote or hearing.
   - The communication identifies the candidate solely as a government official who is in a position to act on the public policy issue in connection with the specific event.
   - The communication identifies the candidate solely in the list of key or principal sponsors of the legislation that is the subject of the communication.

The hypotheticals in the Revenue Ruling make clear that the presence of a few negative factors is not sufficient to tip the balance in favor of a determination of political activity, if positive factors are equally present.

**VII. Other charity communications.** The prohibition on political campaign intervention applies to all of a charity’s activities, not just those that are undertaken during an election year or refer to elections. Some examples follow.

A. **Incumbent voting records.** A charity may publish incumbents’ voting records if follows one of two models:
1. **Neutral publications of voting records.** One model follows the safe harbor rules in Revenue Ruling 78-248 (Situations 1 and 4). Generally, this requires that the charity publish the voting record regularly (such as at the end of each legislative session), include all incumbents regardless of their views, address a wide range of legislative subjects, avoid any editorializing or commentary on specific votes or voting patterns of any legislator, and avoid any implicit approval or disapproval of any incumbent’s voting record in the content or format of the publication.

2. **Member communications regarding voting records.** If the charity does not address a wide range of topics, or makes known its views on how incumbents should have voted, Revenue Ruling 80-282 provides an example of circumstances in which that can still be acceptable. This ruling allowed a charity to publish incumbent voting records on issues important to the charity, indicating whether the legislator voted in accordance with the charities’ position. The charity distributed this voting record to members in its newsletter, without increasing its usual newsletter distribution or targeting distribution particular contested districts. The newsletter made no reference to elections, did not indicate which incumbents were running for reelection, and did not compare incumbents to any candidates who were seeking to replace them. Finally, the organization included a disclaimer pointing out the limitations of judging the qualifications of an incumbent on the basis of a few selected votes, and the need to consider such unrecorded matters as performance on subcommittees and constituent service. Note that, in the Ruling, the charity’s members numbered only a few thousand nationwide; it’s unclear at what point a charity’s membership would be considered too large or concentrated to be covered by the Ruling.

**B. Website links.** Content on a charity’s own website must be nonpartisan; in addition, charities must be cautious about links to other sites that may contain endorsements or other partisan content. In Revenue Ruling 2007-41, the IRS indicated that links to partisan content from a charity’s website could be a violation of the prohibition on political campaign activity, stating that “When an organization establishes a link to another web site, the organization is responsible for the consequences of establishing and maintaining that link, even if the organization does not have control over the content of the linked site.” All facts and circumstances are considered to determine whether a link to a site with partisan material will be considered prohibited campaign activity by the 501(c)(3), including:

- The context for the link on the organization’s website;
- If the links are to candidates’ pages, whether all candidates are represented (this recognizes the possibility of an “on-line” forum or debate meeting the nonpartisan criteria established for permissible live events);
- Any exempt purpose being served by the link; and
The directness of the links between the organization’s website and the web page that contains material favoring or opposing a candidate for public office. The IRS has confirmed, in subsequent guidance, that the number of clicks that separate the electioneering content from the 501(c)(3) organization’s website is a “significant consideration.”

In 2008, the IRS issued a directive to its enforcement field staff regarding how website links should be treated during charity political activity audits. Agents were instructed to differentiate between links to the homepage of related organizations (which are outside the scope of this outline), and links to an unrelated organization’s page. The IRS reiterated that if the link is to an unrelated organization, it will look at the facts and circumstances, and in particular the factors listed above from Rev. Rul. 2007-41, to determine whether the charity is “promoting, encouraging, recommending, or otherwise urging viewers to use the link to get information about specific candidates and their positions on specific issues.”

Charities should be cautious about their website links. This is particularly true since website content is one aspect of a charity’s operations that the IRS can easily spot check, without opening an official audit.

C. **Fundraising.** It’s not just what a charity does that can get it in trouble, but how it talks about what it does: framing accomplishments as political victories can taint otherwise nonpartisan efforts. One charity which claimed in fundraising appeals that its “nonpartisan” voter registration programs had effectively influenced the election or defeat of candidates based on their ideology was subject to penalty taxes by the IRS. See PLR 9609007.

The IRS also fined The Heritage Foundation for allowing Bob Dole, then a Presidential candidate, to sign a widely-distributed fundraising letter which recited much of Dole’s campaign platform as the Foundation’s agenda, to encourage gifts to the Foundation. The letter made no reference to Dole’s status as a candidate or the upcoming election, and the mailings raised substantial donations to the Foundation. Nevertheless, the Foundation’s mailing helped Dole’s campaign, according to the IRS. See TAM 200044038. But later, the IRS allowed charitable fundraising letters to be sent by a charity, again widely believed to be The Heritage Foundation, signed by incumbent candidates, so long as the letters were not mailed into the jurisdiction in which the incumbent might seek re-election. See PLR 200602042.

D. **Using candidates as speakers at charity events.** Charities often use public figures, including political figures who are candidates or may otherwise be seen as partisan, in their educational events or fundraising efforts. (This is distinct from featuring candidates as speakers in their capacity as candidates, discussed above

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7 July 28, 2008, memorandum from Marsha A. Ramirez, IRS Director of Exempt Organization Examinations, Re: Political Campaign Activity on the Internet.

8 See id.
Revenue Ruling 2007-41 clearly allows a charity to ask a public figure to speak at an event in a non-candidate capacity without providing equal time to other candidates. Factors the IRS will look at to determine whether the candidate’s appearance was in a candidate capacity or a non-candidate capacity include:

- Whether the individual is chosen to speak for reasons other than candidacy for public office;
- Whether the individual speaks only in a non-candidate capacity;
- Whether either the individual or any representative of the organization makes any mention of his or her candidacy for the election;
- Whether any campaign activity occurs in connection with the candidate’s attendance;
- Whether the organization maintains a nonpartisan atmosphere on the premises or at the event where the candidate is present; and
- Whether the organization clearly indicates the capacity in which the candidate is appearing and does not mention the individual’s political candidacy or the upcoming election in the communications announcing the candidate’s attendance at the event.

When a candidate is asked to speak at a charity event in a non-candidate capacity, we recommend that the charity take a variety of steps to keep the event nonpartisan, prevent any candidate electioneering from occurring, and protect itself if it happens anyway. (Not all of these steps are necessarily required; nor does following all of them guaranty a favorable outcome before the IRS under the facts and circumstances test described above.) In some cases, it may be wise to explicitly state (at the event, and in publicity materials before and after the event) that the charity does not support or oppose any individual’s candidacy; in other cases, eliminating all references to the election or the individual’s candidacy in connection with the event should suffice.

1. **Before the event:**

   a. Articulate the organization’s non-electoral reasons for inviting the candidate to appear, and its non-electoral reasons for selecting the location (if it is in the district where the candidate is running), the date (if it is close to the election), and the target audience for event publicity. Affirmatively state that the event is intended to be nonpartisan. Board resolutions are one good place to do this.

   b. Review publicity materials and eliminate references to the election, a speaker’s candidacy, or any other appearance of partisanship.

   c. Since any candidate will be a speaker in his or her non-candidate capacity, don’t deal with the candidate’s campaign staff. Make all
logistical arrangements with the speaker personally, or with non-
campaign staff.

d. Brief all speakers in advance on the nonpartisan nature of the event,
with guidelines for what they can and cannot say.

2. **At the event:**

a. Monitor the speakers, and interrupt if needed to remind participants of
the nonpartisan nature of the event, and that the charity does not
support or oppose any candidate or party.

b. Monitor questions from the floor, and have a plan for dealing with
partisan questions.

c. Don’t allow voter registration, campaign fundraising, or distribution of
campaign materials, at the event.

3. **After the event:**

a. Monitor media coverage of the event, and send requests for correction
if the press mischaracterizes the event or your organization as partisan.

b. Create a file with the complete paper trail of all your compliance
efforts, in the event of an IRS audit. Remember, your organization has
the burden of proving it is entitled to its 501(c)(3) status (i.e., that it
has not engaged in prohibited candidate electioneering), and any audit
is likely to occur years after the event.

**VIII. Activities of individuals associated with the charity.** The candidate electioneering
prohibition on charities does not extend to a charity’s Board or staff acting in their
personal capacities. All individuals associated with a charity retain the right to get
involved and take positions in political campaigns. The issue is under what
circumstances the acts of individuals personally involved in candidate campaigns or other
partisan activity will be attributed to the charity because they are deemed to be acting as
the charity’s agents, or the charity authorized or ratified their acts.

A. **Do not use the charity’s resources for campaign activities.** This includes bulk
mailing accounts, email accounts, stationery and logos, telephones, office space,
and compensated time.

B. **Do not allow endorsements or partisan statements at charity events or in charity
publications.** Even if an individual states that his or her partisan statements are
personal views and not those of the charity, they can be attributed to the charity if
they are published on the charity’s website or in other charity publications, or if
they are made as part of the program at an official charity event. This also means
you should not report on an individual’s personal electioneering activities in the guise of “news” in your charity’s publications.

C. Individuals working for a charity and a campaign must take care to avoid any appearance that the charity’s activities have been coordinated with the campaign’s through them. Don’t tell potential donors that their contributions will help defeat or elect any candidate, and don’t use a candidate campaign’s slogan in the charity’s program.

D. Use disclaimers liberally; in any public or media context, the individual should be clear publicly that he or she is acting in a personal, and not official, capacity. For example, don’t sign a candidate endorsement using your official title with a charity. If the individual’s association with the charity will be mentioned in materials relating to a political event, state that the organization is given for identification purposes only, and no endorsement of a candidate by the organization should be inferred. The charity should monitor press coverage for misattributions, and send letters requesting corrections for the record. We suggest having the Board pass a resolution setting out the charity’s nonpartisan position, and posting a nonpartisanship statement on the charity’s website.

E. In extreme cases, the individual may need to resign from his or her role with the charity, at least temporarily, when it becomes too difficult to separate the individual’s actions on behalf of the charity from the individual’s personal partisan activities. This may occur where someone who is closely identified with a charity, or in a leadership role, plans to become a candidate or campaign spokesperson, or to take a full-time paid staff position in a campaign, for example.

IX. Providing space, staff, and other resources to candidates or political organizations.

A. Business transactions with candidates. When a charity enters into business transactions with a candidate, such as renting office space or its mailing list to the campaign, the IRS will apply a facts and circumstances test to determine whether the charity has violated the ban on political campaign activity. See Revenue Ruling 2007-41. Factors to be considered include:

- Whether the good, service or facility is available to candidates in the same election on an equal basis;
- Whether the good, service or facility is available only to candidates and not the general public;
- Whether the fees charged to candidates are at the organization’s customary and usual rates; and
- Whether the activity is an ongoing activity of the organization or whether it is conducted only for a political candidate.

With respect to mailing lists in particular, the IRS has informally expressed the view that a charity has not made its list available to all candidates unless they are all
afforded a reasonable opportunity to rent it. This showing can be made by informing all candidates in the race, in advance of renting to any candidate, that the charity’s list is available for rent.

B. **Resource sharing with political organizations.** A charity cannot subsidize a political organization described in Section 527 by providing it with office space, personnel, mailing lists, etc. for free or at a discount. A charity may engage in transactions with a political organization if it charges full fair market value for goods or services, and any net income is treated as unrelated business taxable income, but only if nonpartisanship is still maintained. As discussed above, expressly offering goods or services to all candidates in a race on the same full fair market value terms can help establish this nonpartisanship.

C. **Coordination with political organizations.** Of course, a charity may not expressly coordinate its activities with a political organization. Less obviously, if a charity conducts its programs in an election year so that its public events, staff work, voter education, etc., just happen to dovetail with a political campaign or party’s work, the charity may either be found to be operating for the prohibited private benefit of the political organization, or to have violated the electioneering prohibition as part of a single, unified election machine.

D. **Training campaign staff.** In 1989, in *American Campaign Academy v. Commissioner*, 92 T.C. 1053, the U.S. Tax Court upheld the IRS’ determination that a campaign training school funded by Republicans, using Republican-oriented classroom materials, whose graduates went to work for Republican candidates, did not qualify under Section 501(c)(3). The rationale was not that the school engaged in political activity, but that its operations resulted in too much private benefit to the Republican Party. Since then, however, organizations designed to train candidates and campaign staffers have obtained recognition of 501(c)(3) status on both the conservative and progressive ends of the political spectrum by avoiding excessive private benefits to any political party or candidate.

This memorandum summarizes information for educational purposes, and is not intended as legal or tax advice. Consult a qualified attorney concerning the application of the law in any specific factual situation.
LOBBYING BY PUBLIC CHARITIES:
An Introduction
Rosemary E. Fei
October 2014

I. The “No Substantial Part” Test.

A. Historical Background.

1. Pre-1930: No statutory restriction on legislative or lobbying activities by charities; a few scattered judicial interpretations.

2. 1930: *Slee v. Commissioner of Internal Revenue.*¹ Denial of charitable tax-exempt status to the American Birth Control League because it disseminated materials to legislators and to the public, advocating repeal of laws preventing birth control, thus precluding it from being exclusively charitable, educational or scientific.

3. 1934: Congress enacts change in definition of an organization qualifying under Section 501(c)(3), requiring that “no substantial part of [its] activities [ ] is carrying on propaganda, or otherwise attempting, to influence legislation.”

4. Legislative lobbying vs. candidate electioneering: The legislative activities restriction should not be confused with the absolute statutory prohibition on participation or intervention in candidate campaigns for public office, enacted by Congress in 1954.

B. Activities clearly not restricted under the “no substantial part” test.

1. Attempts to influence an administrative agency regarding its regulations and rulings.

2. Petitioning the President, or a governor or mayor, on executive decisions.

3. Attempting to influence legislators on nonlegislative matters, such as conducting investigative hearings or intervening with a government agency.

¹ 42 F.2d 184 (2nd Cir. 1930).
4. Engaging in litigation to obtain favorable rulings from the judicial branch of government.

C. Definitional problems: How much is “substantial”?

1. In an early court case, spending less than five percent of the organization’s volunteers’ time and effort (but no money) on lobbying was considered to be insubstantial.²

2. Later decisions³ cast doubt on the usefulness of a percentage test, stating that all the facts and circumstances of an organization’s legislative and other activities would have to be examined.

3. One court found that, even though lobbying contacts were “insignificant,” the time spent formulating positions and deciding whether to lobby was substantial and must be considered.⁴

D. Penalty for engaging in “substantial” lobbying activities: revocation of 501(c)(3) tax exemption, retroactive to the date lobbying activities became substantial. Difficult for the IRS to justify imposing this sanction where the charity has substantial nonlobbying charitable activities, but nevertheless threatens charity’s continued existence.

E. The result of this uncertainty was a severe chilling effect on advocacy activities by charities.

F. The “no substantial part” test is still the law for a charity that does not (or cannot) elect to be governed by Section 501(h) with respect to its lobbying activities. See Section II.B. below.

II. The Section 501(h) Expenditure Test.

A. Enacted as part of the Tax Reform Act of 1976 to clarify the “no substantial part” test, constituting Congressional acknowledgement that some limited lobbying is a charitable activity beneficial to society for which use of deductible gifts is appropriate. Regulations finalized in 1990.

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² *Seasongood v. Commissioner of Internal Revenue*, 227 F.2d 907 (6th Cir. 1955).


1. Section 501(h) states that an organization with lobbying activities does not fail to qualify as tax-exempt under Section 501(c)(3) because of those activities, so long as they are kept below certain dollar expenditure limits. Section 501(h) also imposes a tax on lobbying expenditures above another lower set of limits.

2. Section 4911 provides details on how the lobbying limits are calculated, defines terms (like direct and grass roots lobbying), describes exceptions to definitions, and addresses what expenses count as lobbying expenses.

B. Charities must elect to be governed by Section 501(h). Otherwise, the “no substantial part” test is still the law.

1. Certain charities are not eligible to make the election, based on their foundation status classification: they must remain under the “no substantial part” test.
   a. Churches and related entities.
   b. Governmental units.
   c. Testing for public safety.
   d. Private foundations.  

2. So-called “public charities” may generally make the election.
   a. Educational institutions.
   b. Hospitals.
   c. Organizations supporting government schools.
   d. Organizations publicly supported by grants and donations.
   e. Organizations publicly supported by grants, donations, and exempt function income.
   f. Supporting organizations to public charities.

C. Procedural matters in making the election.

1. One-time filing of IRS Form 5768 at any time during the first tax year in which election will be effective (but lobbying expenditure tracking systems should be in place from the beginning of the year).

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5 Although private foundations are governed by the “no substantial part” test with respect to continued eligibility for exemption, private foundations and their foundation managers are subject to taxes under IRC Section 4945 on “taxable expenditures,” which include amounts paid or incurred “to carry on propaganda, or otherwise attempt, to influence legislation” as defined in that section. Effectively, private foundations are banned from legislative lobbying entirely.
2. Election continues in effect until revoked, also by filing IRS Form 5768. The revocation will not be effective until the tax year after the year in which it is filed.

3. Keep a copy of the Form 5768 as filed, because the IRS ordinarily will not acknowledge receipt.

4. For each tax year in which the election is effective, the charity must complete Part II-A, Schedule C, of IRS Form 990, to report its lobbying expenditures.

5. A charity can switch the Section 501(h) election on and off as often as it pleases.

6. Making the 501(h) election has no impact on an organization’s Section 501(c)(3) status or foundation classification.

D. Section 501(h) focuses on lobbying expenditures, rather than lobbying activities, capping lobbying expenditures as a percentage of exempt purpose expenditures.

   a. Everything spent by the charity to accomplish its exempt purposes is included.
      • Program service expenses.
      • Administrative and overhead expenses.
      • Lobbying expenses.
      • Straight-line depreciation.
   b. The following are not included.
      • Capital expenditures.
      • Expenses related to managing investments.
      • Unrelated business income expenses.
      • Fundraising expenses, but only if paid to an outside vendor primarily for fundraising, or incurred by a separate fundraising unit within the charity.

2. The percentage limits on lobbying expenditures.
   a. The total lobbying limit.
      • 20% of the first $500,000 of exempt purpose expenditures.
      • 15% of the second $500,000 of exempt purpose expenditures.
      • 10% of the third $500,000 of exempt purpose expenditures.
      • 5% of exempt purpose expenditures over $1,500,000, up to a total cap of $1,000,000, regardless of the level of exempt purpose expenditures.
b. The grass roots lobbying limit: one-quarter of the total lobbying limit.

c. To prevent abuse, the Regulations provide that certain closely affiliated charities will be treated as one unit in calculating the lobbying limits.⁶

E. Basic definitions.

1. **Legislation:** **Action** with respect to Acts, bills, resolutions, or similar items by the Congress, any State legislature, any local council, or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure. Legislative bodies in foreign countries are included.

2. **Action:** With respect to legislation, includes introduction, amendment, enactment, defeat, or repeal.

3. **Specific legislation:** Includes both legislation that has already been introduced in a legislative body, and a specific legislative proposal (though it may not have been introduced) that the organization either supports or opposes. Votes to confirm or reject executive branch nominees (e.g., judges) are considered legislation.⁷ Legislation includes a proposed treaty required to be submitted to the Senate for advice and consent, from the time the President’s representative begins to negotiate with the prospective parties to the treaty.

4. **Direct lobbying:** A (i) communication with (ii) any member or employee of a legislative body, or (if the principal purpose of the communication is lobbying) with any government official or employee who may participate in the formulation of the legislation, that (iii) refers to **specific legislation**, and (iv) reflects a view on that legislation.

5. **Grass roots lobbying:** A (i) communication with (ii) the general public or any segment thereof, that (iii) refers to **specific legislation**, (iv) reflects a view on that legislation, and (v) encourages the recipient to take action with respect to the legislation (a “**call to action**”).

6. **Call to action:** Any of the following. The first three are considered **direct** calls to action; the last is considered **nondirect**.

   a. A statement that the recipient should contact a legislator or an employee of a legislative body, or should contact any other government official or employee who may participate in the formulation of legislation.

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⁶ IRC Section 4911(f).

⁷ Charities lobbying on these confirmation votes may be subject to the tax on political organizations under IRC Section 527.
b. A statement of the address, telephone number, or similar information of a legislator or an employee of a legislative body.

c. Inclusion of a petition, tear-off postcard or similar material for the recipient to communicate with a legislator or an employee of a legislative body (or other government official involved in the legislation).

d. Specifically identifying one or more legislators who will vote on the legislation as: opposing the charity’s view on the legislation, being undecided, being the recipient’s representative in the legislature, or being on the committee or subcommittee that will consider the legislation.

F. Selected special rules.

1. **Ballot measures:** Where a communication refers to and reflects a view on a measure that is the subject of a referendum, ballot initiative or similar procedure, the general public in the state or locality where the vote will take place constitutes the legislative body. Accordingly, if such a communication is made to one or more members of the general public in that state or locality, it is direct lobbying. In the case of a measure that is placed on the ballot by voter petitions, an item becomes “specific legislation” when the petition is first circulated among voters for signature.

2. **Communications with members:** A person is a member of a charity if the person pays dues, or makes a contribution of more than a nominal amount of time or money, or is one of a limited number of honorary or life members; members need not have voting rights in the organization. Communications to members on legislation, directly encouraging them to contact legislators, are treated as direct lobbying. If members are asked to go outside the organization and urge nonmembers to lobby their legislators, it is grass roots lobbying.

3. **Mass media advertisements:** A paid mass media ad is grass roots lobbying if it: (i) is made within two weeks before a vote by a legislative body or committee, on (ii) highly publicized legislation, (iii) reflects a view on the general subject of that legislation, and (iv) either refers to the legislation or encourages the public to contact legislators on the general subject of the legislation, even though it does not include any call to action. The presumption may be overcome by showing that the timing of the ad was unrelated to the upcoming vote.
G. Exceptions to the basic definitions, from the statute and the Regulations.

1. **Nonpartisan analysis, study, or research:** An independent and objective exposition of a particular subject matter that includes a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion, is not lobbying, even if a particular position or viewpoint is advocated. The mere presentation of unsupported opinion will not qualify. Further, distribution of the communication may not be limited to, or be directed toward, persons who are interested solely in one side of a particular issue. A communication which includes any direct call to action (see Section II.E.6.) cannot qualify under this exception.

2. **Requests for technical advice:** Providing technical advice to a governmental body or committee in response to a written request by such body is not lobbying. The request must be made in the name of the committee or agency, rather than an individual member of the body.

3. **Self-defense lobbying:** Appearances before, or communications to, any legislative body with respect to a possible decision by that body which might affect the existence of the charity, its powers and duties, tax-exempt status, or deductibility of contributions to it, are not reportable lobbying activities. This exception does not cover legislation, such as an appropriations bill, which (in the eyes of the IRS) merely affects the scope of the charity’s future activities.

4. **Certain member communications:** Communications between the organization and its bona fide members with respect to legislation or proposed legislation of direct interest to the organization and such members, are not lobbying, so long as members are not directly encouraged to lobby.

5. **Other government communications:** Communications with government officials or employees where the charity is not mainly attempting to influence legislation, are not lobbying.

6. **Examinations and discussions of broad social, economic, and similar problems:** This exception covers public discussions, or communications with members of legislative bodies or governmental employees, the general subject of which is also the subject of legislation, so long as such discussion does not address itself to the merits of a specific legislative proposal and so long as no direct call to action is made.

H. Recordkeeping, allocations, and reporting highlights.

1. No guidance in the statute; only general guidance (with some exceptions) in the Regulations: rely on common sense and a good accountant. Use reasonable approaches, applied in good faith and consistently.
2. Out-of-pocket expenses of lobbying (payments to lobbyists, travel to meet with legislators, costs of producing and sending materials, telephone calls, etc.) must be included.

3. Mixed purpose communications (lobbying mixed with fundraising, educational, or other messages) must be reasonably allocated.
   a. If communications sent only or primarily (at least 50% of distribution) to members contain both lobbying and nonlobbying messages, the charity may make a reasonable allocation of costs between the messages.
   b. If a grass roots lobbying message is combined with nonlobbying material in a communication sent to the public, such as a newsletter or a direct mail fundraising solicitation, then, in addition to the cost of the lobbying message itself, any parts of the communication on the same specific subject must be treated as lobbying expenditures as well.

4. Internal overhead expenses (staff salaries, benefits, rent, etc.) must be allocated between lobbying and nonlobbying. A common approach is for paid professional staff to keep time records, showing the hours devoted to direct lobbying, grass roots lobbying, and other activities. This information can be used to allocate payroll and benefits for individual staff; the aggregate percentage of total staff time devoted to the two forms of lobbying can be used to allocate other overhead costs, including costs of non-timekeeping support staff.

5. Expenses to research and prepare lobbying materials are lobbying expenditures. However, expenses to research and prepare nonlobbying materials are also presumed to be grass roots lobbying expenses if the nonlobbying materials are used in a grass roots lobbying communication within six months after they were paid for, and if the primary purpose of the charity in preparing them was for eventual use in lobbying. The presumption is rebutted if, prior to or contemporaneously with the lobbying distribution, the charity makes a substantial nonlobbying distribution of the materials.

I. Penalties for exceeding the limits.

1. If in any year the charity exceeds the total lobbying limit or the grass roots lobbying limit, it must pay a tax equal to 25% of the excess. If the charity exceeds both limits, the 25% tax is imposed only on whichever excess is larger. This tax is automatically due to the IRS with the filing of the Form 990 reporting the excess lobbying expenditures made that year. Use IRS Form 4720 to report and pay the tax.
2. If, over any four year period, the charity’s lobbying expenditures exceed either limit by more than 50%, the charity will automatically lose its Section 501(c)(3) tax-exempt status. Furthermore, the charity is prohibited from converting to a Section 501(c)(4) organization.

III. Deciding whether to make the Section 501(h) election.

Generally, for charities that are eligible and have total exempt purpose expenditures of less than $35 to $40 million, the benefits of electing Section 501(h) substantially outweigh any disadvantages. Some of the facts and factors to consider in deciding whether your organization should make the 501(h) election are:

A. Detailed Regulations under Section 501(h) provide clarity and certainty on a number of common questions. Such clarity and certainty are not available where, as under the “no substantial part” test, the primary source of guidance is a few very dated court cases.

B. The definitions available to an electing charity, which exclude many activities commonly thought of as lobbying, are not available to nonelecting charities. In other words, fewer activities will constitute lobbying under the 501(h) election than under the “no substantial part” test. Some of the more important examples:

1. Using volunteers to lobby.
2. Endorsing legislation without spending money to promote the endorsement.
3. Public commentary on legislation without a call to action.

C. The level of lobbying permitted to smaller organizations (up to 20% of program expenditures) would clearly be considered a substantial activity, in excess of the level permitted under the “no substantial part” test. However, for a charity with a very large budget, lobbying expenditures exceeding $1 million annually (the 501(h) cap) could still represent an insubstantial part of its activities overall. Since the limits are not indexed for inflation, their real dollar value has eroded substantially. Also, because the grass roots ceiling is so low, it is possible that a large charity that only engages in grass roots lobbying could spend more than the annual limit of $250,000 that Section 501(h) permits, and still be able to claim its lobbying was insubstantial relative to the rest of its activities. On the other hand, a small to medium-sized charity (under $20 million/year) that engages in more direct lobbying activity, such as ballot measure campaigns, will find that the 501(h) limit is more generous.
D. A nonelecting charity that fails the “no substantial part” test for even one tax year risks losing its Section 501(c)(3) status. In addition, for each year of excessive lobbying activities, the charity is subject to a 5% tax on the entire amount that it spent for lobbying that year. A 5% tax can also be imposed on organization managers who knowingly, willfully and without reasonable cause agreed to the expenditures.8 For an electing charity, the only penalty for excessive lobbying in a single year is the 25% excise tax.

E. A charity that currently does no lobbying may still make the Section 501(h) election, reporting zero lobbying expenditures on its Form 990, to take advantage of the clearer definitions, and to establish a base of nonlobbying expenditures for future years when it may decide to lobby.

F. For charities that have a companion Section 501(c)(4) lobbying affiliate, electing Section 501(h) permits the charity annually to transfer (by grant or contract) the maximum amounts permitted for direct and grass roots lobbying on issues of concern to the charity.

G. The IRS has assured the charitable sector that electing to be governed by Section 501(h) will not increase a charity’s chances of an IRS audit.

H. Any charity that lobbies must put in place an appropriate accounting system to track lobbying expenditures, whether it elects Section 501(h) treatment or not. All lobbying charities must report their lobbying expenditures on either Part II-A or Part II-B of Form 990, Schedule C; nonelecting charities that lobby must also report on volunteer activities, and provide additional detailed narrative information to the IRS on their lobbying activities. While noncompliance with these reporting requirements for non-electing charities that lobby has been widespread in the past, is it likely that pressure from the press and the public to report lobbying accurately will increase as Form 990s become more easily available and searchable on-line.

I. Under the Lobbying Disclosure Act of 1995, which concerns a range of activities directed towards influencing officials in the legislative and executive branches of the Federal government, electing charities may choose between the tax law’s definitions and the definitions under the Act – whichever is more favorable – in reporting their lobbying activities.

This memorandum summarizes information for educational purposes, and is not intended as legal or tax advice. Consult a qualified attorney concerning the application of the law in any specific factual situation.

8 IRC Section 4912. This penalty tax scheme does not apply to churches and church-related organizations.
"Social enterprise" is a hot topic these days, both inside and outside the exempt organization practitioner’s world. The social enterprise literature is growing by leaps and bounds—a recent search for the phrase "social enterprise" turns up almost 2.5 million hits on Google. Yet uncertainty remains.

Background

One issue is definitional—just what is social enterprise? There have been many different responses,1 for the simple reason that the answer is not simple at all. Different players advance different meanings. Depending on who is attempting to define the term, varying emphasis may be given, for example, to whether a social enterprise operates for private profit and, if so, to what degree.

To further complicate matters, the definition of "social enterprise" differs internationally. In the United States, the term broadly encompasses enterprises that seek to achieve their primary social or environmental missions using business methods (the definition adopted by the Social Enterprise Alliance, a sort of trade association for social entrepreneurs), while in continental Europe the phrase often has a narrower meaning, sometimes conditioned on the presence of specific attributes in the enterprise with less emphasis on its business aspects.2 Faced with this state of affairs, one prominent practitioner and leading light in the field advises his audiences to stop arguing about how to define social enterprise, and just get on with doing it.3 Social enterprise is about change and innovation, which is usually messy, and while this makes most legal practitioners uncomfortable it is a fact of life accepted by social entrepreneurs themselves.

Another significant segment of the legal literature on social enterprise examines various legal forms and funding sources available for conducting social enterprises, not only here in the U.S. but around the world.4 More so than in many areas of law, social enterprise is international in practice. Different national legal regimes—themselves in different stages of development—have responded more or less quickly and in a variety of ways to the challenge of creating new legal constructs for operating activities that are not quite business as usual, nor charity as usual, nor even social change as usual.

In the United Kingdom, social entrepreneurs may incorporate their enterprises as "community interest companies," a special form of entity similar to a normal limited company but tied to a social mission. They may soon have another option, the "social enterprise limited liability partnership" (SELLP), a proposed form of social-enterprise entity based on partnership law. Italy introduced a legal form of social cooperative in 1991 that has seen significant use. Belgium created the societe finalite sociale ("social purpose company," or SFS), a statutory label for otherwise ordinary legal forms of enterprise that meet certain special criteria, including having a central social purpose and not being operated for shareholder profit. France offers the societe cooperative d'intérêt collectif ("collective interest social cooperative," or SCIC), a form of cooperative society with multiple stakeholders (including its employees) and a social mission corresponding to local needs. Other countries, such as Finland, have established special registers of companies organized as social enterprises.

This journal has published a number of articles focusing on the roles and uses of specific legal forms, and this summer, it will sail past a quarter-century mark and become the first tax journal to publish in social enterprise for that long. The following articles are a sampling of the many that have appeared over the last decade on the topics of social enterprises.

ROSEMARY E. FEI is a principal at Adler & Colvin in San Francisco.

The author would like to thank Stephen Chiodini, an associate at Adler & Colvin, for his assistance with this article.
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<td>1985 in Wyoming</td>
<td>2010 in Maryland</td>
<td>Sometime in the late Middle Ages</td>
</tr>
<tr>
<td>Availability</td>
<td>All 50 states</td>
<td>All 50 states</td>
<td>2 states by July 2011</td>
<td>7 states, 2 tribes</td>
</tr>
<tr>
<td>Purposes</td>
<td>For-profit only (may consider constituencies other than shareholders in some states)</td>
<td>For profit, subject visions in Operating Agreement</td>
<td>Dual purpose (social/profit)</td>
<td>No purpose for profit permitted (but profit on activities OK)</td>
</tr>
<tr>
<td>Equity</td>
<td>Shares</td>
<td>Member interests</td>
<td>Shares</td>
<td>Member interests</td>
</tr>
<tr>
<td>Tax on Profit (Rev-Exp)</td>
<td>Yes, at corporate level</td>
<td>Yes, at member level</td>
<td>Yes, at corporate level</td>
<td>Yes, at member level</td>
</tr>
<tr>
<td>Management and control</td>
<td>Board elected by shareholders</td>
<td>Per Operating Agreement</td>
<td>Board elected by shareholders</td>
<td>Per Operating Agreement</td>
</tr>
<tr>
<td>Tax-Deductible Contributions</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Foundation Grants</td>
<td>Yes, with expenditure responsibility</td>
<td>Yes, with expenditure responsibility</td>
<td>Yes, with expenditure responsibility</td>
<td>Yes, with expenditure responsibility</td>
</tr>
<tr>
<td>Capital sources</td>
<td>Sell shares, debt</td>
<td>Sell membership interests, debt</td>
<td>Sell shares, debt</td>
<td>Sell membership interests, debt</td>
</tr>
<tr>
<td>PRIs</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Certifiable as B corporation</td>
<td>Yes, if formed in state w/constituency statute</td>
<td>Yes, w/provisions in Operating Agreement</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
forms of vehicles or investments in social enterprise, such as the low-profit limited liability company or the program-related investment, examining its advantages and disadvantages, addressing technical concerns, providing a detailed how-to guide, or giving examples of how it might be used in typical situations. The discussion below is broader, providing a map, from thirty thousand feet, of the landscape of social enterprise vehicles currently available in the U.S. The discussion is based on Exhibit 1 on page 38.

Each column in the chart represents a legal form (most already existing, but some still only a twinkle in a legislator’s eye) frequently mentioned in the social enterprise sector literature. Each row presents a characteristic across which the chart compares the various vehicles. The selection of what characteristics are included is, admittedly, somewhat arbitrary. Characteristics made the cut if, in the author's experience, they are either especially useful for differentiating among vehicles, or seem to be the subject of misunderstandings or interesting debates.

The legal forms

The business corporation has been around for centuries. The limited liability company (LLC) has been around only for a few decades. Both, however, are entirely familiar to the readers of these pages. In the far right column, "charity" is intended as shorthand for another ancient yet familiar form. Here it refers specifically to the form into which the charity has evolved in the U.S.—the Section 501(c)(3) organization, formed as a nonprofit corporation and qualifying as a public charity rather than a private foundation.

The two newest forms, which are also the least widely available, bear further explanation. The low-profit limited liability company, generally known by the confusing acronym L3C, is available or has been approved in seven states and two tribal areas as of this writing. Essentially, an L3C is an LLC (thus offering limited liability and pass-through tax treatment) that is required under the L3C statute to include additional requirements in its governing document. These requirements include significantly furthering charitable or educational purposes, having no significant purpose of producing income or the appreciation of property, and not being organized to accomplish any political or legislative purpose.

Once an LLC satisfies these requirements, it becomes an L3C, and as such it may have profit-making only as a secondary purpose. In other words, its social mission must come first. This reverses the default rule under LLC statutes, which usually apply traditional fiduciary duties, including the duty of care in avoiding waste and the duty of loyalty to investors above all other constiuencies, absent provisions to the contrary in the LLC’s operating agreement. By qualifying instead as an L3C (where that form is available) these concerns are avoided because the L3C statutory provisions within LLC statutes expressly contemplate and require a primary social purpose for the entity.

Protecting a social enterprise’s managers from liability was not the primary goal of creating the L3C form, however. Even without L3C provisions, LLC laws, unlike corporation laws,
typically give entrepreneurs great structural and governance flexibility, and are broad enough to permit the LLC to focus primarily on a charitable mission. L3Cs, rather, were designed to facilitate investment in social enterprise by private foundations, in the form of program-related investments, or PRIs.

PRIs. PRIs are exceptions to the prohibition, found in Section 4944, on jeopardizing investments by private foundations.8 A debt or equity investment by a private foundation that does not generate returns (whether in the form of interest, dividends, or capital appreciation) high enough to justify the level of risk it represents (in the context of the foundation’s overall portfolio), exposes the foundation, and the foundation managers who approved the investment, to potential liability. If that investment, however, had as its primary purpose the accomplishment of charitable goals, had no significant purpose to produce income or appreciation, and had no purpose of legislative lobbying or participation in candidate elections, it will qualify as a PRI and thereby avoid having to meet a prudent investment standard. The L3C statutes are tailored specifically to impose these PRI requirements on L3Cs in their governing documents, at least as long as the entity retains its L3C status. L3C promoters have asked the IRS to issue guidance that L3C investments are presumptively PRIs, but the IRS has declined to do so. One IRS official stated that “[t]he federal level, no one has really signed off” on the use of the L3C for PRIs and the issue was still being studied.9 As a result, private foundations may not rely on the L3C status of the recipient to meet a prudent investment standard. The L3C will qualify as a PRI and thereby avoid having to justify the investment as prudent in light of the level of risk it represents (in the context of the foundation’s overall portfolio), exposes the foundation, and the foundation managers who approved the investment, to potential liability. If that investment, however, had as its primary purpose the accomplishment of charitable goals, had no significant purpose to produce income or appreciation, and had no purpose of legislative lobbying or participation in candidate elections, it will qualify as a PRI and thereby avoid having to meet a prudent investment standard. The L3C statutes are tailored specifically to impose these PRI requirements on L3Cs in their governing documents, at least as long as the entity retains its L3C status. L3C promoters have asked the IRS to issue guidance that L3C investments are presumptively PRIs, but the IRS has declined to do so. One IRS official stated that “[t]he federal level, no one has really signed off” on the use of the L3C for PRIs and the issue was still being studied.9 As a result, private foundations may not rely on the L3C status of the recipient to meet an automatic determination that a particular investment qualifies as a PRI. So, while formation as an L3C would facilitate the due diligence needed by a private foundation (or its legal counsel) before it may safely make a PRI (or issue a legal opinion that a particular proposed investment qualifies as a PRI), it has not yet proven to be the easy solution to the complexities of making a proper PRI that its promoters may have hoped.10

More troubling, some of the publicity surrounding the L3C form has exaggerated the difficulties of making PRIs to other forms of entity11 or has even suggested that L3Cs automatically qualify for PRIs.12 The fact is that PRIs may be, and often have been, made in business corporations, access to PRI funding does not depend upon the legal form a social enterprise may choose, and a private foundation wishing to make a PRI to an L3C must go through the same due diligence as for a PRI to any other form of entity.13

Flexible purpose/benefit corporation. The very newest vehicle is found in the middle of the chart. It actually encompasses two different legal forms viewed by the author as virtually identical in certain essential ways. The benefit corporation exists (as of this writing) only in Maryland and Vermont;14 the flexible purpose corporation has been proposed and is expected to be adopted shortly in California.

The key characteristics of a benefit corporation, per its governing statute, are that it must create public benefit (and may designate specific public benefits to be created), and that creating such benefits is by definition in the corporation’s best interests. The fiduciary duties of directors of benefit corporations are correspondingly adjusted to allow the directors to

9 See Joseph and Kosaras, supra note 5, for a more detailed explanation of PRIs.
11 See Chernoff, supra note 5, for a general debunking of the various incorrect statements that have been made about the L3C.
12 For example, L3C Advisors, itself an L3C that was launched to promote the form, explained at one point that an L3C was “a perfect vessel for PRI investment without the need for IRS private letter rulings,” implying that private foundations need to obtain a private letter ruling from the IRS when making a PRI, which is not the case. See “L3C and Economic Development,” page 1, available at http://classic.col.org/files/Documents/Conferences/LegislativeandRegulatory.pdf.

11 “L3Cs automatically qualify as ‘Program Related Investment’ (or PRI) for foundations.
12 there is much debate concerning why more private foundations do not make PRIs. In the author’s view, making a PRI often carries a substantial legal compliance cost. More importantly, most private foundations do not have the infrastructure in place to support making PRIs. For example, foundation staff with expertise in traditional grantmaking typically lack the background to employ debt and equity strategies in furtherance of philanthropic ends.
13 Vermont enacted a benefit corporation statute in May 2010, allowing incorporation there as a benefit corporation (or conversion to that status) effective 7/1/11.
consider and weigh, as they deem appropriate, the interests of various stakeholders in determining what is in the corporation's best interests. A benefit corporation is required to report annually to the public and its shareholders on its creation of public benefit and social and environmental value, and its shareholders and directors have standing to enforce these public benefit requirements. Ending benefit corporation status, or a change in control, each requires a two-thirds shareholder vote. (The concept of the benefit corporation as a new legal form was developed by B Labs, a Section 501(c)(3) organization that also advocates for passage of benefit corporation legislation. B Labs is the same organization that promulgates standards for, and certifies, "B Corporation" status. This is not the same as incorporating as a benefit corporation, and is the final characteristic on the chart, discussed below.)

The flexible purpose corporation is still only a legislative proposal. It was developed by a self-appointed working group of members of the California bar to facilitate the creation of companies with combined profit and social or environmental purposes in California. Once the statute is enacted, a flexible purpose corporation would have to specify at least one "special purpose" in its articles of incorporation in addition to traditional corporate profit-maximizing purposes. The special purpose (and flexible purpose corporation status) could be changed only with a two-thirds vote of shareholders. Its directors would be protected from claims of breach of fiduciary duty for trading off profits against achieving the corporation's special purpose. Flexible purpose corporations would have to provide annual impact reports, to the public and their shareholders, to facilitate enforcement of their special purposes.

The proposed flexible purpose statute addresses several technical issues beyond those considered in benefit corporation statutes, and takes a somewhat different approach in some particulars, but the thrust of the two regimes is very similar, which is why they have been combined in a single column in the chart.

Constituency statutes. Finally, the chart refers to business corporations having constituencies beyond their shareholders, and to "constituency statutes." Such statutes began appearing in the late 1980s, and have been adopted in nearly two-thirds of the states as of this writing. Typically, these statutes modify the fiduciary duties of directors under corporate law, allowing them (and in some cases requiring them) to consider more than just the immediate impacts on shareholders in approving corporate actions. Specifically, they can (or must) consider (1) the impacts on such constituencies as employees, customers, suppliers, or the local community, in addition to shareholders, and (2) long-term as well as immediate impacts on shareholders.

Without a constituency statute, case law requires a board to maximize short-term shareholder value, to the detriment of all other metrics, on pain of liability for breach of fiduciary duties. Constituency statutes have the effect of softening or diluting somewhat the laser focus of business corporations on profits and shareholder value. While they provide some justification for directors whose decisions reflect broader values, the problem some see is that they have no teeth. They fall well short of benefit or flexible purpose corporation statutes in that constituency statutes generally do not require directors to weigh public benefit in corporate decision making, give parties standing to enforce public benefit purposes, require transparency on public benefit and social and environmental performance, or protect stated public benefit purposes from amendment, for example.

Characteristics to be considered
The key characteristic that the author used in determining the left-right order in which the columns appear was "purposes," with the vehicles arranged on the spectrum from least charitable (strictly pure profit purposes) to most charitable (no profit purpose permitted). Thus, the flexible purpose/benefit corporation, which comes closest (at least in the author's view) to truly balancing charitable and profit motives in a hybrid form, is in the middle. It is no coincidence that this form is also the newest, least available, and still untested.

Note that with the sole exception of charities, all the legal forms contemplate equity ownership, whether in the form of shares or membership interests. They consequently contemplate raising capital through the sale of such equity interests (in addition to being able to raise capital in the form of debt—although of course only charities may benefit from debt capital in the form of tax-exempt
bond financing. Similarly, all forms except charities are taxed on profits from core activities, whether at the entity or individual owner level. Charities are the only form designed to be funded with donations only, and the only form that provides its donors with a tax deduction for their gifts. Finally, charities are the only one of the legal forms that is not eligible for certification as a “B Corporation,” a characteristic mentioned above and discussed further below. Thus, even with the recent introduction of several new models and forms for conducting social enterprise to fill the gap between business and charity, charities still stand apart from all the others, offering a set of burdens and benefits fundamentally different from all other options.

Having observed charities’ special status in certain respects, it is also worthy of comment to note how all the forms are more or less the same in other respects. For example, legally at least, all forms may be funded by private foundation grants, albeit with private foundations being required to conduct expenditure responsibility in the case of all except charities. Similarly, as discussed above, despite misperceptions on this point, all the forms can legally, and do, receive PRIs from private foundations.

"B Corporation" status. The entry “B-certifiable” in the last row of Exhibit 1 refers to meeting certain standards promulgated by B-Labs. To qualify for “B Corporation” certification, a company must meet a comprehensive set of performance benchmarks relating to social and environmental values. It also must explicitly incorporate consideration of the interests of employees, consumers, the community, and the environment into corporate decision making and must do so in the company’s governing documents. The exact standards depend on the number of employees and the business sector of the entity. B-Labs randomly audits 20% of certified entities every two years to ensure that they continue to meet certification standards. As of this writing, there are 315 certified “B Corporations” in the U.S., Canada, and the European Union.

Some confusion has been created by the designation of a certified business as a “B Corporation” as if that is yet another legal form. It is not. That is why “B Corporation” appears in Exhibit 1 as a characteristic, not a type of entity. “B Corporation” certification is available to any form of legal entity that can meet its requirements—except charities, as noted above. At first glance, this makes some sense, since an essential point of B certification is to provide qualifying businesses with evidence of their commitment to the public good, while charities have the halo conferred by Section 501(c)(3) status. One could stretch the point and analogize B certification for businesses to IRS recognition of Section 501(c)(3) status for nonprofits. Nonetheless, B certification requires demonstration of an organization’s specific practices in various operational arenas such as fair labor conditions and environmentally sustainable business practices. Even with their Section 501(c)(3) purposes and halos, many charities do not embody all the values addressed by B certification in how they operate. Therefore, in the future, it may make sense for charities to be able to seek such certification, and for B Labs to provide it, even though it is not currently available.

Conclusion

The legal world of the social entrepreneur is a rapidly changing one, so the details of this aerial view of the available options will change. Even so, the broad outline it offers can continue to serve as a map through a novel landscape.