Traps for the Unwary: Tax-Exempt Organizations' Compliance with the Intermediate Sanctions Rules and Lobbying and Political Campaigning Prohibitions

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I. Intermediate Sanctions Regulations

A. Overview of Private Inurement and the Enactment of Section 4958:

Charitable and social welfare organizations that are exempt from federal income tax under Sections 501(c)(3) and 501(c)(4) are generally prohibited from having any portion of their income or assets inure to the benefit of any private shareholder or individual. This inurement proscription applies only to "private shareholders or individuals," commonly referred to as "insiders," who typically are individuals that have an influential relationship or position with the exempt organization, such as an officer, director, or a substantial contributor to the organization. Prior to 1996, the sole enforcement mechanism available to the Internal Revenue Service ("IRS") with respect to Section 501(c)(3) organizations, other than private foundations (i.e., organizations classified as "public charities")2, that engaged in transactions with private individuals or for-profit entities which resulted in impermissible private inurement was revocation of the organization’s tax-exempt status, thus the term "intermediate sanctions." The Treasury Department issued both proposed and temporary regulations interpreting and implementing Section 4958, with final regulations being issued and effective on January 22, 2002 (hereinafter, the "Regulations"). Recent administrative rulings and case law demonstrate the IRS’s application and interpretation of the Regulations.3

B. Parties to an Excess Benefit Transaction

The key to understanding the Regulations is identifying the parties that must be involved, each of which are defined below.

1. Unless otherwise indicated, all "Section" references herein are to the Internal Revenue Code of 1986, as amended.

2. An organization that meets the requirements of Section 501(c)(3) is either classified as a (i) "public charity" under one of the four provisions of Section 509(a) (such provisions based primarily on an organization’s sources of financial support), or (ii) a "private foundation." An organization is considered a private foundation if it does not meet the requirements of any of such Section 509(a) provisions. A private foundation typically receives contributions from only a few individuals or entities, whereas a public charity typically receives its income from a broader segment of the general public in the form of gifts, contributions, or receipts from performance of services.


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An “Applicable Tax-Exempt Organization” (hereinafter, the “ATEO”) is an organization that is described in either Section 501(c)(3) or 501(c)(4) and was exempt from tax thereunder at any time during a five-year period ending on the date of an excess benefit transaction (referred to as the “Lookback Period”). A Section 501(c)(3) organization described as a private foundation under Section 509(a) is not an ATEO.4

A “Disqualified Person” is any person who, during the Lookback Period, was “in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization.” Certain family members and 35%-owned entities of a disqualified person are statutorily defined as being disqualified persons. Under the Regulations, certain persons are deemed to have substantial influence, including voting members of the governing body of the organization (board of directors or trustees) and certain officers or positions with similar authority (presidents, chief executive officers, chief operating officers, treasurers). Certain facts and circumstances can also lead to the determination that substantial influence is present including (i) the person founded the ATEO, (ii) the person is a “substantial contributor” based on contributions received by the ATEO in the current taxable year and the four preceding ones, and (iii) the person’s compensation is based mainly on revenues from the ATEO’s activities, including a particular department or function of the ATEO controlled by that person (e.g., a doctor that chairs the cardiology department of a hospital).

An “Organization Manager” is any officer, director or trustee of an ATEO, including an individual having power or responsibilities similar to one of those persons. Generally, an independent contractor (e.g., an attorney, accountant, or investment advisor) or a person who can recommend but not implement action without another’s approval are not deemed to be Organization Managers.

C. Transactions Constituting Excess Benefit Transactions

Excise taxes can only be imposed in instances where an “Excess Benefit Transaction” (hereinafter, an “EBT”) occurs, defined as a transaction in which an economic benefit is provided by an ATEO directly or indirectly to any Disqualified Person and the value of the economic benefit provided by such ATEO exceeds the value of the consideration, including the performance of services, received in return (i.e., the “Excess Benefit”).6 In determining whether an EBT has occurred, all consideration and benefits exchanged directly between a Disqualified Person and the ATEO, or indirectly through a controlled entity or intermediary of the ATEO, must be taken into account. In determining the value of economic benefits for purposes of Section 4958, the Regulations provide that the value of property, including the right to use property, is the fair market value of such property or right. The value of services is “the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (i.e., reasonable compensation).”7 Generally, most components of compensation, whether or not included in gross income, are considered in determining reasonableness under Section 4958.8

Initial Contract Exception to EBTs

Section 4958 does not apply to any nondiscretionary fixed payment received pursuant to an initial contract executed by the ATEO and an individual who is not a Disqualified Person immediately prior to the execution of the contract. A “fixed payment” is an amount of cash or other property specified in the contract, or an amount determined pursuant to a fixed formula set forth in the contract, which is to be paid in exchange for specified services or property. The fixed formula may incorporate an amount that depends upon a specified future event or contingency, provided that no person exercises discretion when calculating the amount of a payment or whether to make a payment. For example, if an ATEO’s board of directors has discretion as to the payment of a bonus, it is not considered a fixed payment. Furthermore, if there is not substantial performance in any year of the contract’s term, this exception will not apply to any fixed payment made during that year.9

Compensation as an EBT

A benefit provided by an ATEO to a Disqualified Person cannot be justified as compensation for services rendered unless the ATEO clearly indicates its intent for the benefit to be compensation for services at the time of payment. This issue most often arises in the context of an ATEO’s compensation of its officers and key employees. The ATEO establishes such intent by “contemporaneous written substantiation” (i.e., the filing of a Form W-2 or 1099 as to the payment of the benefit, or a written employment contract). The substantiation of the payment as compensation is crucial because, under the Regulations,

4. Private foundations are already subject to the extensive self-dealing excise taxes of Section 4941 and the regulations promulgated thereunder which similarly address certain beneficial transactions between private foundations and certain insiders possessing influence and control with respect to the foundation.
5. A “substantial contributor” is defined by Section 507(d)(2)(A) to include any person who contributed or bequeathed an aggregate amount of more than $5,000 to the organization, if such amount is more than 2% of the total contributions and bequests received by the organization in that same year.
8. In addition to cash and non-cash compensation (e.g., salary, bonuses, deferred compensation), other compensatory benefits are included such as medical and dental plan benefits, disability benefits, fringe benefits (other than those excluded under Section 132), severance payments, and life insurance. Treas. Reg. § 53.4958-4(b)(1)(ii)(3).
compensation arrangements are presumed to be reasonable, and thus do not constitute EBTs, provided certain factors are met, as discussed below under "Rebuttable Presumption – No EBT."

**Loans as EBTs**

If an ATEO makes a below-market loan to a Disqualified Person (e.g., the interest rate on the loan is less than the applicable federal rate), such loan constitutes an EBT. In the reverse situation, an above-market loan made by a Disqualified Person to an ATEO will constitute an EBT in the amount of the interest received by the Disqualified Person that exceeds the market value.

**Revenue-Sharing Arrangements as EBTs**

The Taxpayer Bill of Rights 2 authorizes the Treasury Department and the IRS to treat as EBTs any arrangements where the Disqualified Person’s compensation is determined with respect to the revenues of one or more activities of the ATEO. The original proposed regulations under Section 4958 provided standards for determining when a revenue-sharing arrangement constitutes an EBT. However, those standards were withdrawn in both the temporary regulations and the final Regulations. A section of the Regulations is reserved for future guidance. In the interim, ATEOs should ensure that any revenue-sharing arrangement with a Disqualified Person meets the general provisions of the Regulations pertaining to EBTs.

**Rebuttable Presumption – No EBT**

Under the Regulations, compensation arrangements are presumed to be reasonable and transfers of property or right to use property are presumed to be at fair market value provided the following conditions are met: (i) the arrangement or transfer is approved in advance by the ATEO’s “authorized body” (e.g., board of directors or trustees, or authorized committee thereof) composed entirely of individuals without a conflict of interest as to such arrangement or transfer (i.e., no Disqualified Persons benefiting from the compensation arrangement or transfer, or persons with material financial interests in the arrangement or transfer); (ii) the authorized body obtains and relies upon appropriate “comparable data” in making its determination (e.g., compensation paid by similarly situated organizations, both taxable and exempt, for functionally comparable positions, or current independent appraisals establishing the value of the property); (iii) the authorized body documents its determination before the later of its next meeting or 60 days after its final action; and, (iv) the payment is fixed or determined according to a specified fixed formula that is subject to a stated cap. If the above requirements are satisfied, the IRS may rebut the presumption only if it has "sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the [ATEO’s] authorized body." This rebuttable presumption is considered to be the key component in complying with the intermediate sanctions rules.

**D. Correction of Excess Benefit Transaction**

In order to correct an EBT, the Disqualified Person must (i) undo the Excess Benefit to the extent possible, and (ii) take any additional measures necessary to place the ATEO in a financial position no worse than if the Disqualified Person had been dealing with ATEO under the “highest fiduciary standards.” A Disqualified Person can correct an Excess Benefit only by making a payment in an amount that equals the sum of the Excess Benefit plus interest from the date of the occurrence of the EBT until the date of the correction. The Disqualified Person may also return the property to the ATEO to correct the EBT if such transaction involved specific property and the ATEO consents. If the EBT arises under an employment agreement or other contract that has only been partially performed, such agreement or contract may need to be amended to prevent continued Excess Benefit, but need not be terminated in order for a correction to be effective.

**E. Excise Taxes Imposed Under Section 4958**

The amount of potential excise taxes imposed under Section 4958 can be substantial. Disqualified Persons are subject to a first-tier tax of...
25% of the amount of the Excess Benefit. If the EBT is not corrected within a certain period of time, a second-tier tax of 200% can also be imposed on the Disqualified Person. If a tax is imposed on the Disqualified Person, a separate excise tax of 10% of the Excess Benefit (up to a maximum of $10,000 per excess benefit transaction) can also be imposed on each Organization Manager who "knowingly" participated in or approved such EBT, unless such participation was not "willful" and was due to "reasonable cause." No tax is imposed on the ATEO itself.

II. Prohibitions on Lobbying Activities by Section 501(c)(3) Organizations

In addition to proscribing private inurement as discussed above, Section 501(c)(3) imposes two additional requirements upon an organization seeking tax-exempt status:

1. no substantial part of the entity’s activities may involve attempting to influence legislation; and
2. the entity may not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

These requirements are often referred to collectively by the generally stated rule that "tax-exempt organizations are prohibited from lobbying."

A. What is Meant by "Lobbying"?

Lobbying is commonly understood to be an attempt to seek to influence legislators in hopes of procuring or producing a specific legislative outcome. Section 4911(d) defines "influencing legislation" as either:

1. indirect "grassroots" lobbying designed to create or affect public opinion: "any attempt to influence legislation through an attempt to affect the opinions of the general public or any segment thereof," or
2. direct lobbying: "any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of the legislation."

Certain activities or communications, however, are not considered to be "lobbying." The following activities are permitted by tax-exempt organizations:

- publishing nonpartisan research — such published research may inform policymakers and/or may conclude that a certain policy is good or bad, but it cannot call for enactment or defeat of specific legislation;
- providing technical advice or assistance to a government body or committee at the request of such body;
- appearances before or communications with any legislative body relating to the existence, powers, tax-exempt status, etc., of the organization itself and/or the deduction of contributions to the organization;

Communications between the organization and its members about legislation or proposed legislation of direct interest to the organization and such mem-

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19. The EBT must be correct within the "taxable period," which begins on the date the transaction occurs and ends on the earlier of (i) the date of the mailing of the notice of deficiency with respect to the first-tier tax, or (ii) the date on which such tax is assessed. Treas. Reg. § 53.4958-1(c)(2)(ii).

20. "Knowing" means that a person has actual knowledge, not reason to know, of facts sufficient to determine that the transaction is an EBT and negligently fails to make a reasonable attempt to ascertain that it is or in fact knows that it is one. Reliance on professional advice can negate the knowledge element. Treas. Reg. § 53.4958-1(d)(4)(i)-(iii).

21. "Willful" means voluntary, conscious, and intentional. However, an Organization Manager's participation is not willful if the manager does not know that the transaction constitutes an EBT. Treas. Reg. § 53.4958-1(d)(5).

22. Reasonable cause exists if the manager has exercised responsibility owed to the organization with ordinary business care and prudence. Treas. Reg. § 53.4958-1(d)(6).

23. Lobbying is permitted by organizations characterized as Section 501(c)(4) and Section 501(c)(6) organizations. Section 501(c)(4) organizations are civic, social welfare and "action" organizations. These are organizations not qualified as "charities" under Section 501(c)(3). Such an organization may engage in unlimited lobbying (direct and grassroots), so long as the lobbying is directly related to the purpose of the organization. However, such an organization may not advocate for or against candidates in campaigns for public office. Section 501(c)(6) organizations consist of business leagues, trade associations, professional associations, chambers of commerce, real estate boards, and boards of trade. Such an organization may engage in unlimited lobbying (direct and grassroots), so long as the lobbying serves the common interest of the members of the organization. If the organization does engage in lobbying, then a member's dues relating to such activity cannot be deducted by the member as a Section 162 business expense.

25. Id.
B. What is Considered Impermissible “Politicking/Electioneering”?

The prohibition against lobbying is coupled under Section 501(c)(3) with a prohibition against participation in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for public office. In other words, this constitutes a prohibition against politicking or electioneering.

The bright line prohibition appears to be that “Thou shalt not support or oppose any specific candidate for any elective office.” IRS seems to suggest that this prohibition is absolute, and that even a small infringement will result in the organization’s loss of tax-exempt status.35 But, in fact, the IRS has permitted the following activities:

- Voter education is permitted, such as distributing candidates’ voting records, so long as the education effort is even-handed and does not advocate for or against a specific candidate or party.
- The organization may sponsor voter registration drives.
- The organization may sponsor debates between candidates.
- The organization may publish candidate responses to questionnaires.
- The organization may provide facilities for candidates to make campaign speeches.
- An attempt to influence the Senate confirmation of a federal judicial nominee appears to be permitted — since the nominee is not a contestant for elective public office.

On which side of the bright line does expressing and publicizing a general view on an issue which is subject to a voter referendum fall? For example, may a tax-exempt organization express a view and take a stand with respect to a state or local referendum regarding whether gambling, carrying concealed weapons, etc., should be allowed or disallowed? If the purpose of the communication or activity is to influence or shape public opinion on the issue, it is likely permitted as grassroots lobbying. A tax-exempt organization should be able to pursue its own cause or mission, as long as its efforts do not directly benefit a particular contestant.

C. Short History Lesson

In 1954, while serving as a U. S. Senator from Texas, former President Lyndon B. Johnson bitterly complained that tax-exempt groups had helped his opponent in a difficult primary election. Congress agreed that using tax-deductible contributions for ads, brochures, etc., for or against a particular candidate was an unfair subsidy of one candidate over another. Section 501(c)(3) jurisprudence has been characterized as “a consistent saga of ill-considered and piecemeal development.”... Exempt organization law in general, and particularly the law concerning political activities of exempt organizations, has been driven by anecdotal accounts of perceived abuses of tax-exempt status. Rule after rule has been passed with little or no discussion, and with little or no serious consideration by anyone but the individuals who are outraged by the anecdotes or who sense themselves to have been victimized by the purported abuses. What has emerged is a series of wide-sweeping responses driven by small problems and uninformed by careful consideration of the broader perspective.

D. The Meaning of “Substantial Part” has been Difficult to Pin Down

It has been suggested that the line between substantial and insubstantial falls somewhere between 5% to 16% of the organization's total activities.44 In Sensongood v. Commissioner,45 where less than 5% of an organiza-

43. Laura Brown Chisolm, Sinking the Think Tanks Upstream: The Use and Misuse of Tax-exemption Law to Address the Use and Misuse of Tax-Exempt Organizations by Politicians, 51 U. Pitt. L. Rev. 577, 620 (1990).
45. 227 F.2d 907, 912 (6th Cir. 1955).
tion's expenditures were for lobbying, the activities were found to be insubstantial. In Haswell v. U.S., an organization was found to be in violation of the substantial part limitation by directing 16-17% of its expenditures to lobbying.

Section 501(h) provides certainty to some, but not all, Section 501(c)(3) organizations by permitting a qualified organization to make an election (using Form 5768) that its lobbying expenditures will not exceed a certain amount. Churches, church auxiliaries or associations of churches cannot make this election. Permitted lobbying expenses (“PLE”) are the lesser of $1,000,000 or a specific safe harbor dollar amount of “exempt-purpose expenditures” (what the organization spends to accomplish its mission, net of fundraising expenses) (“EPE”). In addition, the organization may spend up to 25% of the PLE for “grassroots” lobbying. If the organization spends over $20,000 in one year, the organization must report under the Federal Lobbying Disclosure Act. In June 2002, IRS issued a very simple informational letter to Independent Sector, a Washington, D.C. charity, which serves as a helpful overview of guidelines that charities, other than churches, can follow with respect to lobbying activities to avoid losing their tax-exempt status.

E. The “Substantial Part” Test is Largely a Facts and Circumstances Test

Courts have been unable to precisely define what constitutes a substantial part of an organization’s activities, with judges in essence finding that they know it when they see it:

• Regan v. Taxation With Representation of Washington: a non-profit corporation organized to promote certain interests in the field of federal taxation was denied tax-exempt status because IRS determined that a substantial part of the corporation’s activities would consist of attempting to influence legislation. The corporation challenged the prohibition against substantial lobbying as violating the First Amendment (free speech rights) and the equal protection component of the Fifth Amendment’s due process clause.

   (veterans’ groups are tax-exempt and can lobby, but charities cannot lobby). Held: the prohibition against lobbying by charities does not violate either the First Amendment or the Fifth Amendment due process clause. (Congress has the power to discriminate between veterans’ groups, permitting them to lobby because of the debt the

46. 500 F.2d 1133, 1146-47 (Ct. Cl. 1974).
47. I.R.C. § 501(h)(5).
48. If EPE is under $500,000, then PLE equals 20% of EPE; if EPE is $500,000 to $1,000,000, then PLE equals $100,000 plus 15% of EPE over $500,000; if EPE is $1,000,000 to $1,500,000, then PLE equals $175,000 plus 10% of EPE over $1,000,000; if EPE is over $1,500,000, then PLE equals $225,000 plus 5% of EPE over $1,500,000.
nation owes them, and charities in general).

• The Nationalist Movement, a Mississippi Non-Profit Corporation v. Commissioner: a charitable organization seeking tax-exempt status advocated social, economic and political change in the U.S. (specifically espousing white supremacist/anti-minority views) by publishing and distributing newsletters, producing a cable TV program, conducting a telephone counseling service, and participating in public speeches, rallies and parades. IRS denied the application for exemption. Held: the organization's activities were not qualified as "educational," and denial of tax-exempt status did not violate the organization's due process and equal protection rights.

• Christian Echoes National Ministry, Inc. v. U.S.: a charitable organization holding a tax-exempt determination letter conducted religious radio and TV broadcasts and published written materials advocating anti-communism/socialism. IRS revoked its exemption. Held: even "indirect" communication to legislators (not just direct paid lobbying contacts) and "broad" public appeals designed to sway voters are impermissible under Section 501(c)(3) where such activity constitutes a substantial part of the organization's activities.

F. The IRS's Sporadic, Erratic and Inconsistent Enforcement of the Substantial Part Test has Led to Accusations of Selective Prosecution

The defense that the government should not be permitted to selectively prosecute alleged violations has generally not been successful.

• Branch Ministries v. Commissioner: a church's tax-exempt status was revoked for placing campaign-related advertisements. The church alleged that IRS violated the Equal Protection Clause of the Fifth Amendment by engaging in selective prosecution. In support of its contention, the church submitted several hundred pages of newspaper excerpts reporting political campaign activities in, or by the pastors of, other churches that retained their tax-exempt status. These included reports of explicit endorsements of Democratic candidates by clergymen as well as many instances in which favored candidates had been invited to address congregations from the pulpit. The court held that the church failed to establish that it was similarly situated to other churches and thus did not establish that selective prosecution had occurred.

• In 1997, Newt Gingrich was found to have violated the rules regarding using tax-exempt funds where funds raised by a charitable foundation were contributed to his political action committee and used to broadcast a college course taught by him. After a highly politicized investigation by an independent prosecutor, it was determined that Gingrich and the organizations in question had impossibly used tax-exempt funds to further his political goals.

III. Conclusion

The recently finalized intermediate sanctions rules are complex and technical, with little guidance to date on how the IRS will enforce them. In contrast, we have more guidance with respect to enforcement of the long-standing restrictions on lobbying and political campaign activities, but clearly such enforcement has not been consistent. Because of the technical complexities, an apparent increase in IRS scrutiny of tax-exempt organizations in general, and the uncertain enforcement environment, tax-exempt organizations are advised to be well-versed in these rules and remain alert to further developments.