Money in Politics: A Hydraulic or a Legal Issue?

Trevor Potter

Lloyd Leva Plaine Distinguished Lecture

52nd Annual Heckerling Institute on Estate Planning

January 23, 2018

I. Introduction: 501(c)(4)s in the tax code

Thank you. It’s a pleasure to be here with you today, delivering the Lloyd Leva Plaine Distinguished Lecture. Back in the 1980s, when I first started advising campaigns as a lawyer, I could not have imagined that I would have anything to say to this Institute—but, then, I would never have dreamt that tax-exempt organizations would come to play such an influential—but secretive—role in our elections.

Back then, all non-profits were largely barred from spending money in federal elections since they were almost all incorporated, and therefore subject to the federal corporate independent expenditure ban. Even after the Supreme Court’s decision in Massachusetts Citizens for Life in 1986, which allowed “small associations” of citizens organized as 501 c4s to make independent political expenditures, they were prohibited from using any funds from for-profit corporations to do so. But since the Supreme Court’s 2010 decision in Citizens United v. FEC removed all limits on corporate spending in federal elections, 501(c)(4)s have reported spending at least $626 million on election activity.1

To be sure, I am talking about a very small and special subset of c4s. There were more than 80,000 501(c)(4)s registered in fiscal year 2016.2 In many ways, the c4 category has become a catchall for groups seeking exempt status that do not seem to fit elsewhere in the tax code. A quick glance at the range of groups currently classified as c4s shows this heterogeneity; the category includes groups like the American Kennel Club, for example, which was founded in 1884.3

But I’m not here to talk about the American Kennel Club, fine organization that I am sure it is. Under 10 percent of c4s report any political activity,4 and of those only a relative handful are major players in elections. But that handful of essentially political organizations doing business as 501 C organizations are of particular concern to those of us who focus on money in politics. That’s because these organizations have become the entity of choice for political donors

---

seeking to spend money on elections without having their names publicly disclosed. It is that double characteristic that gives these 501 Cs their current prominent role in our politics: they may (a) legally spend unlimited money, including corporate money, in elections, and (b) keep their funders secret from the public. That is NOT true of entities organized as political organizations under federal or state laws.

As this roomful of tax experts may be aware, the Internal Revenue Code defines section 501(c)(4) organizations as “Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.”

So, the first question is: How did organizations that exist “exclusively” for the promotion of social welfare end up neck deep in the world of political campaigns? What does “exclusively” mean? Many might be inclined to define it as the Oxford English Dictionary does: “to the exclusion of others; only.”

Since 1959, however, the IRS has generously chosen to interpret “exclusively” not as “only,” but rather as “primarily.” So 501(c)(4)s are permitted to engage in political campaign intervention, as long as that isn’t their “primary” purpose.

But what does this mean, in practice? Well, the IRS regulations fail to answer two questions that are central to controversies over c4 political activity: First, what constitutes political campaign intervention, and, second, how much campaign intervention may a c4 engage in before it impermissibly becomes that group’s “primary” activity?

These questions have only become important since 501 Cs became the vehicle of choice for political actors seeking to influence elections without registering as PACs at the FEC or with states, and thus avoiding disclosure of their funders. The story of how the 501 Cs have taken on this role is worth telling.

II. Federal Election Law: Pre-Citizens United History

Our modern federal campaign finance system dates to the 1970s. The Federal Election Campaign Act, first passed in 1971, and then substantially amended in the wake of Watergate, established new contributions limits and disclosure requirements for federal candidates, political committees, and political parties. It recodified prohibitions on corporate and labor spending in federal elections. The 1974 amendments also created the Federal Election Commission as an independent regulatory agency to administer and enforce the new law.

---

Opponents of these reforms soon challenged them in court, and in 1976 the Supreme Court issued its landmark *Buckley v. Valeo* decision, which upheld most of the new law and found that contribution limits and disclosure requirements were constitutional.

However, the Court also found a constitutional distinction between contributions and expenditures: the Court upheld limits on contributions to candidates but, it reasoned that direct expenditures by individuals, without coordination with a candidate, constituted protected speech. The Court therefore struck down limits on how much individuals could spend on political advertising independently of candidates. Importantly, both contributions to, and expenditures by, political committees are required to be publicly disclosed in filings with the FEC, now available online, as are independent political expenditures.

Despite the *Buckley* court upholding the limits on the size and sources of campaign contributions, and requiring disclosure, over the course of the next two decades, candidates, parties, and corporations and unions sought to create new loopholes in the law. Of course, they had ingenious lawyers, so they succeeded.

For one, in the 1990s, parties started raising more and more money that exceeded federal contribution limits and disclosure requirements. This was known as “soft money.” The legal theory—based on a wink and a nod—was that national party committees could raise unlimited funds for their non-federal activities. These “non-federal” activities eventually were extended to include TV ads featuring and attacking federal candidates—but without “expressly” calling for their election or defeat.

This soft money fundraising would often be accomplished by raising funds for state parties in states that had no contribution limits, and then using these funds for federal elections or transferring them to federal party committees.

Corporate interests, prohibited from spending money in elections, began paying for what came to be derisively known as “phony issue ads.” These were ads that attacked or supported candidates but that stopped just shy of expressly urging their election or defeat, thereby avoiding the definition of “election expenditure” as interpreted by the Supreme Court in *Buckley*. As the Supreme Court itself noted later in 2003, this created a situation in which, quote, “Little difference existed, for example, between an ad that urged viewers to ‘vote against Jane Doe’ and one that condemned Jane Doe’s record on a particular issue before exhorting viewers to ‘call Jane Doe and tell her what you think.’”

Concerned by these trends, a bipartisan group of legislators got together to try to close these loopholes. The result was the 2002 passage of the McCain-Feingold reform law.

Taking aim at phony issue ads, McCain-Feingold created a new category of ads subject to disclosure of contributions and contribution limits, called “electioneering communications.”

---

Electioneering communications are defined as ads that air within 30 days of a primary or 60 days of a general election, and which refer to a candidate in that election—even without expressly advocating their election or defeat. The sources of funding for these ads was required to be disclosed, and could not include corporate or labor money.

McCain-Feingold, too, was challenged in the courts, but in 2003 the Supreme Court upheld, by a 5-4 vote, almost all of the new law in McConnell v. FEC, including the new electioneering communications disclosure requirements.

III. Citizens United v. FEC

Three years after that decision, Justice Samuel Alito replaced Justice Sandra Day O’Connor, and ever since then a different and contrary 5-4 majority of the Court has taken an adversarial approach to campaign finance regulations. I believe it is relevant that, for the first time in more than two centuries, NONE of the current Justices is a former elected officeholder: not one has run for or held political office; not one has raised money for their campaign, or had first hand experience with the dangers of corruption inherent in contributions of large sums of money to candidates and their political parties, or of the risks of unlimited expenditures of funds by special interests in elections.

The first campaign finance case the post-O’Connor Court faced was FEC v. Wisconsin Right to Life, in 2007. In it, the Court undid part of the new ban on the use of corporate money for electioneering communications. It ruled that the law could require the disclosure of funding for electioneering communications, but that Congress could not ban corporate or labor funding for electioneering communications unless the ads included express advocacy. With Chief Justice John Roberts declaring “enough is enough”—speaking of the provision he was striking down—the new Court’s ideological goal of undoing the post-Watergate campaign finance system was made clear.

Then, in 2010, the Supreme Court’s decision in Citizens United v. FEC eliminated entirely the historical prohibition on corporate expenditures in federal elections. The Court held that independent expenditures could not corrupt candidates, that the First Amendment did not distinguish between individuals and corporations, and that, therefore, corporations could not be prohibited from making independent expenditures in any election—federal, state, or local.

However, the Court in Citizens United also upheld federal disclosure laws. In a section of the opinion joined by seven other Justices, Justice Kennedy emphasized the importance of “prompt disclosure of expenditures”:

“With the advent of the Internet,” Kennedy wrote, “prompt disclosure of expenditures can provide shareholders and citizens with the information needed to hold corporations

---

and elected officials accountable for their positions and supporters. Shareholders can
determine whether their corporation’s political speech advances the corporation’s
interest in making profits, and citizens can see whether elected officials are ‘in the
pocket’ of so-called moneyed interests.”

However, Justice Kennedy has complained in recent years that the disclosure he envisioned is
“not working the way it should.” Indeed, it is not.

One consequence of Citizens United apparently NOT expected by the Supreme Court was the
creation of so-called super PACs. Soon after Citizens United, the D.C. Circuit reasoned that,
because Citizens United found that independent expenditures posed no risk of corruption, the
logical corollary was that contributions to committees that only make independent
expenditures also cannot corrupt, and therefore cannot be limited. This decision led to “super
PACs,” which are political committees that can raise and spend unlimited amounts from
individuals, corporations, and unions, so long as they only use those funds to make
independent expenditures, rather than contributions to candidates. As political committees,
super PACs file regular reports with the FEC disclosing their contributors and expenditures.

Another major consequence of Citizens United, totally contrary to the expectations of the
Supreme Court majority that spoke of “full disclosure of corporate spending to shareholders,”
was the decision by corporations to avoid spending money on political advertising directly, and
thus putting their names on the advertising messages, or even to give funds to the new super
PACs that report their donations.

Corporations realized that shareholders—or customers—might dislike their political choices,
and hold them accountable. Instead, thanks to the ability to leverage the gaps between the FEC
rules and the IRS rules, they discovered that they could give to 501(c)4 and (c)6 organizations
that could do the very same political spending without disclosing their participation to their
shareholders—or to the public.

Thus the Citizens United decision helped usher in a new era of so-called dark money: 501(c)
groups that don’t disclose their donors have reported spending more than $800 million on
federal elections since 2010. Certainly much of this is corporate funding—especially by 501c 6
organizations, which are business associations. And that’s only the political spending they are
required to report—political ads aired more than 30 days in advance of a primary or 60 days
ahead of a general election are not covered by these filing requirements, nor are direct mail
pieces and robo calls.

11  Paul Blumenthal, Anthony Kennedy’s Citizens United Disclosure Salve ‘Not Working,’ HUFF. POST (Nov. 2,
12  Political Nonprofits (Dark Money), supra note 1.
IV. The Political Fight for Disclosure Since 2010

As I have noted, the Supreme Court authoritatively stated that all of the new spending it unleashed in *Citizens United* would be **fully disclosed**. So what went wrong? The reality is that our federal regulatory agencies have abysmally failed to enforce and update disclosure standards in this new era, and the deep partisan deadlock in Congress on this issue has prevented any action there.

My former agency, the Federal Election Commission, bears much responsibility for the explosion of “dark money.”

By law, the six-member FEC requires four affirmative votes to take any action: to open a rulemaking, to adopt new regulations, or to begin an investigation to determine whether the law has been violated.

In recent years the FEC has been crippled, thanks to an enormous rise in partisan 3-3 deadlocks. As a result, it has failed to adopt **new rules** in response to a quickly-changing campaign finance landscape. And, the FEC now routinely deadlocks and fails to enforce those rules that are on the books. The Commission’s general dysfunction has sharply reduced the number of enforcement votes it takes in the first place.

For example, under FEC rules, the test to determine whether an entity is a federal political committee subject to FEC reporting and disclosure requirements is the so-called “major purpose test”: Is federal campaign activity the group’s major purpose?

This question of political committee status became a major issue after *Citizens United*, when we began to see a flood of new groups organized as c4s but seemingly engaged in little else besides political activity.

Crossroads GPS, for example, was formed as a 501(c)(4) by the creators of the new Super PAC American Crossroads, after the PAC’s fundraising lagged because it had to disclose its donors. In total, in the 2010 election cycle, Crossroads GPS, the c4, reported to the FEC that it spent $39.1 million. According to the FEC General Counsel’s estimates, the group spent $20.8 million on what the FEC considered federal campaign activity (both on express advocacy and candidate-specific advertising).13 That’s **53 percent** of its total spending.

The FEC’s General Counsel therefore found that GPS must register as a political committee. However, the FEC ultimately deadlocked, and failed to support its General Counsel’s conclusion. Crossroads GPS is still not registered as a PAC, or publicly reporting its donors.

Finally, as I have noted, federal law states that **independent political speakers**—those who expressly advocate the election or defeat of a candidate, whether they are political committees

---

or not—must disclose their funding and spending. Thus, even 501(c)(4)s should theoretically be disclosing their donors to the FEC if they run campaign ads.

The challenge for the FEC was that these disclosure provisions were drafted for a pre-Citizens United world, where corporations and unions were prohibited from making such expenditures. Once corporations were freed to spend in elections, the imaginative argument was made that for-profit corporations making political expenditures would have to report the identity of every consumer who bought a product from them, since their consumers were the “source” of their funds.

There were a number of ways the FEC could have interpreted disclosure laws to guarantee voters information about the sources of election spending without requiring that every organization disclose every commercial transaction. But the FEC adopted the narrowest possible reading of the disclosure law, to require only the disclosure of those who gave to corporations—non-profit and for-profit alike—for the “purpose” of funding a particular political ad.

As a result, when a 501(c)(4) uses funds from its general treasury to pay for an electioneering communication, only those donors who had contributed for the purpose of furthering specific electioneering communications must be reported to the FEC and publicly disclosed. Most 501(c)(4)s, therefore, can easily evade the disclosure requirements by claiming that no contributors gave for the purpose of funding specific advertisements. Thus, almost no 501 Cs report their donor to the FEC when they undertake political expenditures.

All of this leaves us with an agency that is not doing the job it was created to do. Our democracy has suffered as a result.

Meanwhile, the IRS has had its own problems with ambiguous rules and variable enforcement. As this room is well aware, the IRS uses an ambiguous “facts and circumstances” test to decide whether a particular expenditure constitutes intervention in a political campaign. The IRS has published lists of examples of facts and circumstances that qualify as political activity, but the test remains vague and has generated significant controversy.

The height of this controversy came in 2013, with the so-called Tea Party Scandal. In the midst of an exploding number of 501(c)(4) applications, the IRS looked for ways to distinguish between true social welfare organizations and organizations that should be classified as political groups. During this period, the agency was widely criticized for allegedly singling out 501(c)(4)s with associated terms like “Tea Party” and “patriot.” However, despite claims of an Obama administration targeted attack on Tea Party groups, an investigation found the IRS in fact was looking for political activity by c4 applicants across the political spectrum; other keywords it searched for included “Occupy,” “progressive,” and “medical marijuana.”

Unfortunately, this Washington scandal has significantly hampered enforcement efforts and made the IRS highly reluctant to attempt to classify c4s as political organizations.

And not only is it unclear what constitutes political activity for IRS purposes, it is also unclear how much political activity is too much. Campaign intervention cannot be a c4’s “primary purpose,” but what does that mean? The IRS, for example, granted Crossroads GPS c4 status in 2014, despite the group reporting tens of millions in political spending to the FEC.  

The same year as the so-called Tea Party controversy, the IRS attempted to engage in a rulemaking to address two questions: What counts as political campaign intervention? And, what proportion of activity must be social welfare-related in order to meet the “primarily” standard? The resulting proposed rules were criticized as both overbroad and under-inclusive, so the IRS issued another Notice of Proposed Rulemaking. However, this was stopped in its tracks in 2015, when Congress used the appropriations process to forbid the IRS from engaging in any rulemaking “relating to the standard which is used to determine whether an organization is operated exclusively for the promotion of social welfare for purposes of section 501(c)(4)...” That congressional prohibition on any efforts by the IRS to clarify the law has been included in subsequent appropriations bills, including the one that passed last month.

The Securities and Exchange Commission has also failed to make Citizens United’s disclosure promises a reality. Although Justice Kennedy’s opinion in Citizens United asserted that disclosure would allow shareholders to know how their money was being spent, the reality has been that a publicly traded corporation’s contributions to 501(c)(4) and 501(c)(6) political organizations are never publicly reported.

The SEC has received petitions requesting it adopt rules requiring transparency in political spending for publicly traded corporations. However, as was the case with the IRS rulemaking, Congress attached a rider to the 2015 appropriations bill forbidding the SEC from moving forward with rulemaking “regarding the disclosure of political contributions, contributions to tax exempt organizations, or dues paid to trade associations.”

Since Citizens United, Congress itself also has repeatedly failed to pass legislation which would clarify the disclosure requirements for political speech—the same disclosure that Justice Kennedy said in Citizens United was necessary for democracy.

---

After *Citizens United*, Democratic Senators—but no Republicans—proposed the DISCLOSE Act, which among other changes would have required 501(c)(4)s to report much more of their political activity, including independent expenditures that are more than $10,000.\(^\text{19}\)

Similarly, the Shareholder Protection Act has been introduced repeatedly in both houses of Congress since *Citizens United*. If passed, the bill would require corporations to disclose to the SEC their political spending—including by identifying which candidates they supported or opposed—and to alert shareholders and the public to political expenditures over a particular amount.\(^\text{20}\)

And both Congress and the IRS contributed to the demise of another potential check on 501(c)(4)s. The year following *Citizens United*, the IRS appeared to be starting to enforce gift taxes on contributions to 501(c)(4)s,\(^\text{21}\) but Republican members of Congress objected to this move.\(^\text{22}\) As a result, the IRS backed away from its examination of the issue,\(^\text{23}\) and in 2015 Congress formally passed a gift tax exemption for contributions to 501(c)(4)s.\(^\text{24}\)

And there’s another, related, benefit to individuals who donate to c4s: As Professors Roger Colinvaux and Brian Galle have recently pointed out, contributing appreciated property to a c4 is not a taxable event. Therefore, donors can not only avoid public identification and gift taxes, but they can also avoid paying taxes on the appreciation of their contributed assets. This is not the case for political committees (527s), whose donors do have to pay capital gains taxes on contributions.

V. Other Avenues for Political Spending not Subject to Donor Disclosure

The political spending path blazed by 501(c)(4)s has led to the use of other 501(c) categories for political activities. 501(c)(6)s operate similarly to 501(c)(4)s and include trade associations like the U.S. Chamber of Commerce and the Koch’s Freedom Partners.

---


In fact, the Internal Revenue Code grants more than 20 categories of 501(c) groups exempt status, including veterans groups organized under 501(c)(19). Such groups don’t have to disclose their donors, and many can and do engage in political activity—except for 501(c)(3)s, which may not—as of this moment!

VII. c3s

The charitable contribution deduction—for donations to organizations under Section 501(c)(3)—dates back to the War Revenue Act of 1917. Then, in 1954, Senator Lyndon B. Johnson proposed what became known as the Johnson Amendment, which prohibited political intervention by 501c3 charities. This was passed by a Republican Congress and signed by a Republican President, Dwight Eisenhower.

The reasoning behind this prohibition is very clear: taxpayers subsidize 501(c)(3)s for charitable, religious, and educational work, not for partisan political activity.

Both Congress and the Courts historically have agreed, and have repeatedly upheld this important provision. In 1999, for example, a D.C. District Court emphasized the government’s “compelling interest in maintaining the integrity of the tax system and in not subsidizing partisan political activity.”25

But there have been recent political recent efforts to roll back, or completely eliminate, this prohibition. These proposals originated in politically active churches, largely on the right.

Back in February of last year, President Trump’s second month in office, he gave a speech to C-PAC where he promised to “get rid of and totally destroy the Johnson Amendment.”26

Then, a partial repeal of the Amendment was almost included in the December tax bill—it was in the House version, but was excluded from the Senate bill because it didn’t comply with the Senate’s rules on germaneness. The legislation began as an exemption for speech in churches, but was quickly expanded to cover political activity “in the normal course of business” by all c3s.

Although repeal of the Johnson Amendment did not end up in the 2017 tax bill, it is clear the plan to allow c3s to intervene in elections is not dead—there is now a possibility it will reappear in the Appropriations process.

While it was still part of the tax plan, the nonpartisan Joint Committee on Taxation came up with an astounding estimate on the impact this would have. They estimated that it would cost

26 Heather Long, In small win for Democrats, the final tax bill will not include a provision allowing churches to endorse political candidates, WASH. POST (Dec. 14, 2017), https://www.washingtonpost.com/news/wonk/wp/2017/12/14/in-small-win-for-democrats-the-final-tax-bill-wont-include-a-provision-to-allow-churches-to-endorse-political-candidates/?utm_term=.f999ee7e5a78
the U.S. government more than $2 billion over 10 years.27 A big reason for this is that they anticipate that a lot of donors would shift their political donations away from c4s and toward c3s—up to $6 billion worth.

VII. SOLUTIONS

So, where are we, and where do we go from here?

First, for those of us who believe in the rule of law, the current reality is dangerously lawless, and unacceptable. To have the FEC routinely deadlock on all important matters before it vitiates the law it exists to enforce. To have Congress pass riders buried in Appropriations bills prohibiting the IRS or the SEC from clarifying what their laws mean when there is obvious confusion is disingenuous at best. If Congress does not like the current laws, it should change them—not prohibit the expert agencies from interpreting and enforcing them. The fact that all of this is being done by the leaders of one party, currently in the majority, largely out of public view, to advance what they believe in in their partisan interests, is offensive to the broader public interest.

Like the weekend government shut-down in Washington, this is no way to run a railroad—or a democracy. Aside from the legal and regulatory muddle it creates, political activity by groups that don’t disclose their donors also opens the opportunity to corruption of officeholders. Voters do not know who is “in the pocket of the special interests,” in Justice Kennedy’s phrase. Donors may engage in quid pro quo corruption, and these non-disclosing groups can certainly be used to engage in pay-for-play, and to hide the identity of foreign entities seeking influence in our elections. Polls show that vast majorities of Americans understand this, and that it lessons their faith in our system of representative government.

These problems are not without possible remedies. In particular, the problem of how to ensure disclosure of political donors could be addressed if Congress and regulatory agencies were committed to doing so.

Two things Congress could do would be to pass the DISCLOSE Act and the Shareholder Protection Act. A third would be to allow the IRS and SEC to engage in rulemaking on these issues.

The FEC could also do a lot, even under current law. For example, it could write new rules requiring the disclosure of c4 donors, if the c4s engage in significant political activity. Or, without even writing new rules, it could classify dark money c4s like Crossroads GPS as political committees—so that they would have to register with the FEC and disclose their donors.

---

But this will only happen if the FEC has commissioners who believe in its mission and who can work together to enforce the existing laws. There is currently one vacancy on the Commission, and the remaining five Commissioners are serving on expired terms. This means that the agency may be re-made in the near future—but in which direction?

These steps will take concerted political effort, which will only occur if those who care about our democracy step up and demand it. I am an optimist, so I believe that will happen. The alternative is a continued slide down a slope to a dark swamp full of alligators eating our representative system of government alive—a swamp presidential candidates of both parties last year promised to drain.

Thank you.