Tax Law

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IRS Issues Liberal Ruling Regarding Exempt Organizations and Political Action Committees

Authors: Donald J. Fitzgerald | Eric S. Jones

Last month the IRS issued Private Letter Ruling 201127013 (the "Ruling"), which held that an organization classified as a Section 501(c)(3) public charity (the "Parent") will not lose its Section 501(c)(3) tax-exempt status as a result of (i) a controlled Section 501(c)(4) entity's ("501(c)(4) Organization") establishment and operation of two political action committees, SPAC and FPAC, and (ii) the Parent and its subsidiaries' ("Tax-Exempt Subsidiaries") establishment and operation of a voluntary payroll deduction plan for employees to contribute to any Section 527 political organization.

Facts

By way of background, the Parent is a comprehensive, regional, integrated health care system. The network provides a full range of health care services including diagnosis, treatment, research, education, medical equipment and home health care. The Parent is either the sole member or holder of all issued and outstanding shares of stock in each of the Tax-Exempt Subsidiaries.

Neither the Parent nor the Tax-Exempt Subsidiaries participate or intervene in political campaigns on behalf of any candidates for public office. The 501(c)(4) Organization will be a separate nonprofit membership corporation, the voting stock of which will be held by the Parent and the nonvoting stock will be held by Tax-Exempt Subsidiaries. The Ruling does not address the issue, but presumably the Parent, as sole voting member, controls selection of the board members and officers of the 501(c)(4) Organization.

The Ruling states that a majority of the 501(c)(4) Organization's board of directors will consist of members of the Parent's or the Tax-Exempt Subsidiaries' board of directors, officers or employees. Additionally, the Parent's treasurer or assistant treasurer will serve as the 501(c)(4) Organization's treasurer.

What the Ruling terms to be an "incidental" part of the 501(c)(4) Organization's activities will be to establish SPAC and FPAC. SPAC's and FPAC's initial boards and officers will be appointed by the chairperson of the 501(c)(4) Organization, who presumably was appointed chairperson by the Parent. A majority of both SPAC's board of directors and FPAC's board of directors will consist of members of the board of directors of the 501(c)(4) Organization (also appointees of the Parent). The treasurer of the 501(c)(4) Organization (who is also the treasurer or assistant treasurer of the Parent) will serve as treasurer for both SPAC and FPAC.

Newsletter Editors

Donald W. Meaders
Partner
Email
310.312.4345

Donald J. Fitzgerald
Partner
Email
415.291.7420

Practice Area Links

Practice Overview
Members

Authors

Donald J. Fitzgerald
Partner
Email
415.291.7420

Eric S. Jones
Associate
Email
310.312.4138

The Ruling states as a fact, without explanation, that the 501(c)(4) Organization will operate independently of the Parent and its Tax-Exempt Subsidiaries. Given the membership, voting power and management of the 501(c)(4) Organization, it is unclear how the IRS made such a factual determination. The Ruling also states as a fact that the PACs will operate independently of the 501(c)(4) Organization and each other.

Finally, the Parent and the Tax-Exempt Subsidiaries plan to offer a payroll deduction plan for their employees, pursuant to which they can elect to have a voluntary contribution to any Section 527 political organization deducted automatically and forwarded to that organization.

Law and Analysis

Section 501(c)(3) organizations, the contributions to which are generally tax-deductible, are absolutely prohibited from participating or intervening, directly or indirectly, in political campaigns on behalf of any candidates for public office. On the other hand, Section 501(c)(4) organizations, the contributions to which are generally not tax-deductible, are allowed to conduct such activities, as long as they are not the primary activity. A Section 501(c)(4) organization may incur a tax under Section 527 if it makes political expenditures, however.

Citing case law and administrative authority, the IRS found that as long as (i) the 501(c)(4) Organization was separately incorporated; (ii) the organizations keep adequate records to show that tax-deductible contributions are not used to pay for nonexempt purposes; and (iii) the organizations operate independently of each other and administer their own affairs separately, the political activities of the 501(c)(4) Organization would not be attributed to the Parent.

Additionally, citing legal authority, the IRS concluded that the voluntary payroll deduction plan did not constitute participation or intervention in political campaigns because the beneficiary political organizations were not selected by the Parent nor did such organization have any influence over the chosen organizations.

Thoughts and Concerns

Many tax attorneys have been concerned that a structure like that in the Ruling would cause the Parent to lose its Section 501(c)(3) tax exemption on the basis that it was intervening in political campaigns indirectly through the “controlled” Section 501(c)(4) Organization. However, in the Ruling the IRS did not object to the evident control features of the arrangement despite the fact that those control features would enable the Parent to direct the 501(c)(4) Organization to engage in political activities (itself or through the PACs) favored by the Parent. The Ruling states as a fact that the various parties in the Ruling would operate independently of each other but provided no analysis supporting this crucial determination. An alternative view of the arrangement described in the Ruling might be that it was devised by the Parent precisely so that the 501(c)(4) Organization and the PACs would not act independently of the Parent. Additionally, the IRS states as a fact that the establishment of SPAC and FPAC are “incidental” activities of the 501(c)(4) Organization. They do not, however, provide any metrics showing how to test for such activities being “incidental.”

The “independence” and “incidental” facts are critical to the conclusion

that the Parent will not lose its Section 501(c)(3) tax-exempt status. Any parties interested in receiving a similar ruling will need to convince the IRS that such facts are present, a task that may well prove perplexing considering that it is uncertain how the IRS came to feel comfortable reciting them as facts in the Ruling.

It should be noted that the Ruling is not binding as to any party, other than the one who applied for it, but it does serve as an indication of administrative practice at the IRS. Additionally, this newsletter is a general summary of the Ruling, the specific application of which depends on the facts and circumstances. Manatt, Phelps & Phillips, LLP's tax attorneys stand ready to assist you with any questions you may have.

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