SOCIAL WELFARE ORGANIZATIONS: BETTER ALTERNATIVES TO CHARITIES?

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INTRODUCTION

Traditionally, charitable activities have been carried out by charities, those organizations described in § 501(c)(3) of the Internal Revenue Code (the "Code").[1] Charities, comprising both public charities and private foundations, have historically engaged in grantmaking activities as well as direct service activities. One advantage of charities is that contributions to charities generally, although not always, are eligible for a federal income tax deduction under § 170(a) since most charities described in § 501(c)(3) are eligible donees described in § 170(c).[2] Other benefits flowing in the wake of qualification under § 501(c)(3) include exemption from federal income tax at the entity level; exemptions from income, real property, and sales and use taxes in most states; postal rate reductions; and, for certain eligible charities, the right to issue tax-exempt bonds.[3] In addition, gifts to charities are generally deductible for federal gift and estate tax purposes.[4] Hand in hand with these benefits of charitable status, however, are significant burdens. These burdens include a non-distribution constraint,[5] restrictions on lobbying and legislative activities,[6] and a prohibition on political campaign activities.[7]

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1. I.R.C. § 501(c)(3) (2012).

2. I.R.C. §§ 170(a), (c). There is an exception for organizations testing for public safety, which, although described in § 501(c)(3), are not listed in § 170(c) and are not eligible recipients of income-tax-deductible donations. Rev. Rul. 65-61, 1965-1 C.B. 234; I.R.S. G.C.M. 32,399 (Sept. 21, 1962), modified by I.R.S. G.C.M. 32,519 (Feb. 20, 1963).

3. Basil Facchina, Evan A. Showell & Jan E. Stone, *Privileges & Exemptions Enjoyed by Nonprofit Organizations*, 28 U.S.F. L. REV. 85, 85-86 (1993).

4. I.R.C. §§ 2055, 2522.

5. I.R.C. § 501(c)(3); *see* Henry B. Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 56 (1981).

6. I.R.C. § 501(c)(3).

7. *Id.*

Traditional analyses of charitable giving behavior suggest that the charitable contribution income tax deduction is an incentive for giving to eligible donees, such as churches, schools, hospitals, cultural organizations, direct service providers, private foundations, and other charities. But that charitable contribution deduction is only available to persons who choose to itemize their deductions (rather than relying on the standard deduction), and—given that less than one-third of all taxpayers itemized in 2016[8]—it seems clear that other incentives exist for charitable giving for at least some of the over $300 billion donated to charities in that year.[9]

The Tax Cuts and Jobs Act signed by President Trump in December of 2017[10] amends various provisions of the Code, and some of those amendments are likely to reduce further the number of itemizers to perhaps fewer than ten percent of taxpayers.[11] Accordingly, the federal income tax charitable contribution deduction will serve as an incentive to fewer taxpayers. For some charities, such as churches and soup kitchens, where many if not most of the donations arrive in the form of cash contributions and in-kind donations of clothing and food, the charitable contribution deduction incentive is likely to be even less significant to their donors. Furthermore, large donors, such as Bill Gates and Warren Buffett, often get only quite trivial federal income tax deductions for their charitable gifts (because of the limitations on such deductions),[12] and thus must be motivated by something other than income tax benefits to stimulate their philanthropy. Given the burdens of charitable status and the limited incentive of the charitable contribution deduction for many donors, it is not surprising that, in recent years, major donors increasingly have opted to use vehicles

8. *See* Ellen P. Aprill, *Examining the Landscape of § 501(c)(4) Social Welfare Organizations*, 21 N.Y.U. J. LEGIS. & PUB. POL'Y 345, 405 & n.347 (2018).

9. Press Release, Giving USA, Giving USA 2017: Total Charitable Donations Rise to New High of $390.05 Billion (June 12, 2017), https://givingusa.org/giving-usa-2017-total-charitable-donations-rise-to-new-high-of-390-05-billion/.

10. The Act is generally referred to as the "Tax Cuts and Jobs Act of 2017" even though, as a result of the Senate Parliamentarian's application of the so-called "Byrd rules," that title was excised from the final form of the Act which, instead, has the actual title of "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." Pub. L. No. 115-97, 131 Stat. 2054, 2054.

11. *See* Aprill, *supra* note 8, at 406 & n.351.

12. I.R.C. § 170(b). Warren Buffet's 2015 tax return showed that his charitable contributions deductions were limited to just under $3.5 million whereas his charitable donations exceeded $2.85 billion, so his deductions amounted to just over 0.12% (i.e., 12/100ths of one percent) of his donations. Sruthi Shankar, *Buffett Hits Back at Trump Over Tax Comments*, REUTERS (Oct. 10, 2016, 12:55 PM), https://www.reuters.com/article/us-usa-election-buffett-idUSKCN12A1Z0.

other than charities to carry out their charitable purposes. These alternative vehicles include social welfare organizations, described in § 501(c)(4). Although § 501(c)(4) organizations are tax-exempt at the entity level[13] and gifts to these social welfare organizations are not subject to federal gift tax,[14] most of the other benefits flowing in the wake of a contribution to a charity are not available for gifts to social welfare organizations.

The 2017 Annual Conference of the National Center on Philanthropy and the Law, held at New York University School of Law, addressed the use of § 501(c)(4) social welfare organizations to accomplish traditionally charitable activities, including grantmaking and provision of direct services, and assessed the benefits and burdens of utilizing social welfare organizations to those ends.

The first Conference panel, entitled "History and Policy: Mapping Social Welfare Organizations," was anchored by an article by Professor Ellen Aprill.[15] In her article, Professor Aprill reviews relevant law and legislative history regarding § 501(c)(4) and explores troubling "border skirmishes" in identifying and regulating § 501(c)(3) and § 501(c)(4) organizations. Professor Aprill states that § 501(c)(4) is a "catch all" and a "dumping ground" for a "dizzying array of organizational missions, structures, sizes, and activities."[16] She suggests several changes to the tax treatment of § 501(c)(4) organizations, including the taxation of investment income for social welfare organizations that provide benefits to members,[17] taxing appreciation on assets donated to § 501(c)(4) organizations,[18] and taxing non-membership social welfare organizations on the lesser of their investment income or the amount spent on lobbying. In the end, though, Professor Aprill acknowledges that it is unlikely that any of these proposed changes will be enacted, and that "it is likely that we

13. I.R.C. § 501(a).

14. *Id.* § 2501(a)(6).

15. John E. Anderson Professor of Tax Law, Loyola Law School, Los Angeles.

16. Aprill, *supra* note 8, at 348.

17. This change was suggested in an article by Professor Daniel Halperin, of Harvard Law School, that also appears in this volume. Prof. Halperin suggests applying this tax to social welfare organizations that provide more than incidental benefits to members, Daniel Halperin, *The Tax Exemption Under I.R.C. § 501(c)(4)*, 21 N.Y.U. J. LEGIS. & PUB. POL'Y 519, 528 (2018), while Prof. Aprill would create a "bright line" and apply the tax on investment income of any § 501(c)(4) with members who receive any benefits beyond the legal rights of members under state law to vote for directors and on major corporate changes, Aprill, *supra* note 8, at 400.

18. This change was suggested in an article by David Miller, Esq., that also appears in this volume. *See* David S. Miller, *Social Welfare Organizations as Grantmakers*, 21 N.Y.U. J. LEGIS. & PUB. POL'Y 413, 436 (2018).

will continue to live with the current version of § 501(c)(4) and all its uncertainties."[19]

In the second article in this volume, David Miller, Esq.,[20] explores the use by major donors of both domestic and foreign social welfare organizations as grantmakers for charitable purposes, an activity historically the domain of private nonoperating foundations qualifying as charities described in § 501(c)(3).[21] Mr. Miller concludes that for the "super-wealthy"[22] donor, "[s]ocial welfare organizations are . . . much better vehicles . . . than § 501(c)(3) organizations because the exemption of capital gains tax on the donation of appreciated property is a far more valuable tax benefit than the charitable deduction."[23] He argues, and seeks to demonstrate through examples, that the exclusion of capital gains tax on the donation of appreciated property to social welfare organizations perpetuates income inequality and distorts the hierarchy among organizations described in § 501(c) by placing § 501(c)(4) organizations above § 501(c)(3) organizations in appeal for the "super-wealthy." Mr. Miller concludes that the law should be changed to treat the donation of appreciated property to any organization described in § 501(c) as a sale for income tax purposes in order to "restore most-favored tax treatment to § 501(c)(3) organizations and eliminate a tax subsidy that is far more valuable to wealthy donors than to others."[24]

In the third article in this volume, Professor Lloyd Hitoshi Mayer[25] explores the use of social welfare organizations in another typically charitable endeavor in a paper for a panel on "Social Welfare Organizations as Service Providers."[26] His article, entitled "A (Partial) Defense of § 501(c)(4)'s 'Catchall' Nature," explores the vagueness of the legislative history and Internal Revenue Service ("IRS") interpretation of § 501(c)(4) that has led commenters, including Professor Aprill, to criticize social welfare organizations as a "catchall" category of exempt organization.[27] Professor Mayer departs from traditional focus on lobbying and political social welfare organizations, and turns his attention to less common types of social welfare organizations,

19. Aprill, *supra* note 8, at 409.
20. Partner, Proskauer Rose, LLP.
21. Miller, *supra* note 18, at 417-18.
22. *Id.* at 437.
23. *Id.*
24. *Id.* at 436.
25. Professor, Notre Dame Law School.
26. Lloyd Hitoshi Mayer, *A (Partial) Defense of § 501(c)(4)'s "Catchall" Nature*, 21 N.Y.U. J. LEGIS. & PUB. POL'Y 439 (2018).
27. *Id.* at 445; Aprill, *supra* note 8, at 348.

including those that provide goods and services rather than political or legislative intervention. He argues that "not only is the 'catchall' nature of § 501(c)(4) not inconsistent with its language and limited legislative history, but that nature is generally defensible as the appropriate tax classification for these various entities."[28] The only identified exceptions to this contention involve two types of organizations that use qualification under § 501(c)(4) to avoid classification under other, more restricted regimes than the social welfare classification provides: organizations that would be classified as charities under § 501(c)(3) but are subject to the stringent rules that apply to private foundations,[29] and electric and water cooperatives that Congress intended to exempt exclusively under § 501(c)(12).[30] Professor Mayer concludes that while "qualification for [§ 501(c)(4)] status is generally justifiable both under the theoretical basis for exemption and the overall structure of the Code's exemption and related provisions," including taking into account apparent congressional intent, the use of the statutory provision to avoid necessary rigorous regulation of private foundations and electric and water cooperatives could "potentially undermine" the structure of the Code's exemption provisions.[31] With those exceptions, Professor Mayer argues that the "catchall" exemption provided under § 501(c)(4) is logical and desirable and should be neither limited nor curtailed.

Professor Roger Colinvaux,[32] in the fourth article in this issue, addresses the use of social welfare organizations in a more typical role of political activity, surmising that social welfare organizations function as "essentially unregulated vehicle[s] for partisan speech."[33] His article explores the inconsistencies in the laws applying to social welfare organizations and political organizations[34] that mislead the public and confuse regulators. Professor Colinvaux urges consistency in disclosure and financing rules between social welfare and political organizations, and explores various suggestions for reform to that end, including taxing the investment income of social welfare organizations, expanding the exempt status of political organizations to include social welfare income, taxing social welfare organizations' political

28. Mayer, *supra* note 26, at 441.

29. *See* I.R.C. §§ 4940-4948 (2012).

30. Mayer, *supra* note 26, at 465.

31. *Id.* at 479.

32. Professor of Law, Columbus School of Law, The Catholic University of America.

33. Roger Colinvaux, *Social Welfare and Political Organizations: Ending the Plague of Inconsistency*, 21 N.Y.U. J. LEGIS. & PUB. POL'Y 481, 482 (2018).

34. I.R.C. § 527.

expenditures, and enforcing the "no subsidy norm" by imposing a proxy tax on § 501(c)(3) organizations that would apply to the extent of grants to a social welfare organization that engages in political activity.[35] His concluding proposal is to eliminate definitional limits on the political activity of social welfare organizations in order to eliminate restrictions on the free speech of social welfare organizations currently imposed under § 501(c)(4).[36]

In the fifth article in this volume,[37] Professor Daniel Halperin[38] calls for reconsideration of the federal income tax treatment of organizations described in § 501(c)(4).[39] Professor Halperin argues that permitting exemption at the entity level without a charitable contribution deduction subsidizes only organizations that accumulate funds[40] while denying subsidy to organizations that spend money currently. He maintains that this exemption from tax on investment income is a subsidy that can be justified for charities but not for "mutual benefit"[41] organizations, and explains that in many cases, the tax exemption for mutual organizations is limited to income from transactions with members, as is the case for social clubs described in § 501(c)(7).[42] Professor Halperin concludes that social welfare organizations that engage in campaign activities "should be aligned with the treatment of political parties."[43] He further contends that "[s]ection 501(c)(4) organizations that provide more than incidental benefits to members should be taxed like social clubs."[44] Professor Halperin favors removing the subsidy of tax-exemption on accumulations from most § 501(c)(4) organizations and treating those organizations like social clubs for federal income tax purposes.

In the final piece in this volume, Rosemary Fei[45] and Eric Gorovitz[46] explore the use of social welfare organizations as lobbying organizations, a role traditionally embraced by both charities and so-

35. Colinvaux, *supra* note 33, at 449-517.
36. *Id.* at 513.
37. Halperin, *supra* note 17. The article was not presented at the October 26-27, 2017, conference but is included here because its focus on § 501(c)(4) organizations is very relevant to the other papers that were presented at that conference.
38. Stanley S. Surrey Professor of Law, Emeritus, Harvard Law School.
39. Halperin, *supra* note 17, at 534.
40. This structure exempts investment income from tax and thus favors organizations with endowments.
41. I.R.C. § 501(c)(7) (2012).
42. Daniel Halperin, *Income Taxation of Mutual Nonprofits*, 59 TAX L. REV. 133 (2006).
43. Halperin, *supra* note 17, at 534.
44. *Id.*
45. Principal, Adler & Colvin.
46. Principal, Adler & Colvin.

cial welfare organizations.[47] The authors argue for changes in rules to reduce real and perceived obstacles by charities to facilitate and increase lobbying directly by charities. The piece describes currently available options for lobbying by a charity, under a test that limits lobbying to an "insubstantial" portion of the charity's activities.[48] That substantiality can be measured under either a subjective test[49] or a more objective, safe-harbor test[50] that sets numerical caps for dollars that may be spent on lobbying without violating the requirements for exemption.[51] The piece continues to explain that social welfare organizations, unlike charities, can lobby without limitation, and describes a commonly used "tandem" arrangement where a charity and a social welfare organization may operate together to accomplish the lobbying goals of the charity, although contributions to the social welfare organization are not deductible for federal income or estate tax purposes. Finally, the authors suggest a new structure to facilitate lobbying by charities, making the use of a social welfare organization or a "tandem" arrangement less necessary. The proposed structure, to be called a Separate Segregated Lobbying Fund (SSLF), would not be a separate legal entity but rather would consist of a fund or bank account held by a charity for lobbying purposes. The SSLF would be treated for tax purposes as a separate § 501(c)(4) entity but without the ability to engage in political campaign activity. Amendments to current statutory and regulatory law would be required to enable the creation and use of an SSLF. The authors argue that enabling the use of this structure would remove some of the obstacles to lobbying by charities by relieving charities "not only of the burden of setting up a whole new organization, maintaining it, and policing the boundaries between the charity and its affiliated social welfare organization, but also eliminat[ing] what clients often perceive to be the unacceptable risk of having partisan political activities of the affiliate attributed to the charity."[52] Fei and Gorovitz conclude that the ability to employ an SSLF would increase the ability of charities to participate in national legislative debate and process without the risks and burdens inherent in the tandem structure.

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47. Rosemary E. Fei & Eric K. Gorovitz, *Practitioner Perspectives on Using § 501(c)(4) Organizations for Charitable Lobbying: Realities and an Alternative*, 21 N.Y.U. J. LEGIS. & PUB. POL'Y 535, 552 (2018).

48. I.R.C. § 501(c)(3) (2012).

49. *Id.*; *see* Treas. Reg. § 1.501(c)(3)-1 (as amended in 2017).

50. I.R.C. §§ 501(h), 4911.

51. *Id.*

52. Fei & Gorovitz, *supra* note 47, at 574.

The papers in this volume provide a deep and detailed view of the current and potential uses of social welfare organizations to engage in activities for public good. They add importantly to the sparse literature on this topic and highlight substantial benefits available to funders and nonprofit leaders eager to serve the public using a flexible and advantageous structure. Social welfare organizations are more flexible and less heavily regulated than public charities and private foundations and can be used effectively to deliver similar public benefits. Accordingly, exempt organizations described in § 501(c)(4) increasingly are used by well-advised donors willing to forego the federal income tax charitable contribution deduction. As the wealthy become wealthier and fewer taxpayers itemize, increased use of social welfare organizations for traditionally charitable purposes is both inevitable and desirable.