

# AN EXEMPT STATUS SORTING HAT

*Responding to Lloyd Hitoshi Mayer, A (Partial) Defense of § 501(c)(4)'s "Catchall" Nature*

*Response by Richard Schmalbeck\**

Professor Lloyd Mayer provides a very detailed and insightful description of the elements of § 501(c)(4) of the Internal Revenue Code (the "Code").<sup>1</sup> He refers to § 501(c)(4) as a "catchall" category, and this seems clearly true. He also addresses the question of whether there is anything wrong with the section's catchall nature, focusing primarily on organizations that might qualify under some other paragraph of § 501(c), or some other code section, but that are nevertheless categorized under § 501(c)(4). Mayer concludes that there may indeed be a problem with the section's catchall nature, though only in relatively few cases: largely those where § 501(c)(4) status is or might be used to escape some restriction associated with the alternative classification that the organization wishes to eschew. In those situations, he argues, Congress may need to act to "clarify" that the alternative classification is in fact the only permissible one.<sup>2</sup>

As Mayer's descriptions make very clear, there is often ambiguity about the "right" category in which to place an organization. This creates difficulties for the organizations themselves, but also for the Internal Revenue Service ("IRS") and the courts. The Tax Court, for example, has lamented that:

Trying to understand the various exempt organization provisions . . . is as difficult as capturing a drop of mercury under your thumb. . . . Rarely is it clear that an organization would qualify only

---

\* Simpson Thacher & Bartlett Professor of Law, Duke University. A.B., University of Chicago, 1970; J.D., University of Chicago, 1975.

1. Lloyd Hitoshi Mayer, *A (Partial) Defense of § 501(c)(4)'s "Catchall" Nature*, 21 N.Y.U. J. LEGIS. & PUB. POL'Y 439 (2018).

2. Professor Mayer uses this language on page 477 of his article, in reference to utilities cooperatives, one of a few areas in which he sees significant potential for abuse. One might well ask whether this is a clarification of the existing rules or simply a new rule, as I will discuss herein.

under one of the categories . . . and often it is clear that an organization would qualify under a number of the categories . . . .<sup>3</sup>

Under current law and administrative practice, the organization itself makes the initial choice of the category under which it seeks exemption. But does it have to be that way? This approach opens up multiple abuse opportunities, as organizations that might fit more naturally under one set of provisions opt instead for another, presumably because the other category has more privileges, or fewer restrictions, than the natural category.

Indeed, this situation is behind one of the greatest crises that the IRS has ever faced. Early in this decade, the IRS became concerned with the efforts to achieve recognition of exempt status under § 501(c)(4) by organizations that seemed more naturally to qualify as political organizations under § 527.<sup>4</sup> But in addressing this problem, the IRS committed errors in processing that have come to be known as “targeting the Tea Party.”<sup>5</sup>

One might begin by asking: were these organizations indeed qualified for exemption under § 501(c)(4)? In many, perhaps most, of the cases that generated this controversy, I think the answer should be: no, they are not. But even if the organizations *could* so qualify, it is appropriate to ask whether they *should*, and also whether the organization as an entity should have the sole power to decide which category it may enlist in achieving exempt status.

Instead of allowing the organization to choose the category under which it seeks exemption, an alternative possibility would be to have organizations submit an application on a generic form—perhaps a variant of the current form 1024, used for organizations seeking § 501(a) exemption. The IRS would review each organization’s application, possibly asking, as it does now, for additional information if necessary, and then the IRS would decide on the most appropriate pigeon-hole for that organization.

---

3. Weingarden v. Comm’r, 86 T.C. 669, 675 (1986), *rev’d*, 825 F.2d 1027 (6th Cir. 1987).

4. This appears to have been spurred by the decision of the Supreme Court in *Citizens United v. Federal Election Commission*, 558 U.S. 310 (2010), which effectively allowed unlimited campaign spending by nonprofit corporations.

5. The principal error was choosing to use a search strategy to identify applications needing detailed processing that used “tea party” and “patriot” as the search terms. Although the IRS also used terms emblematic of left-leaning tendencies (such as “progressive”), it appears that more right-leaning organizations than left-leaning ones ended up being singled out for more extensive processing.

What I have in mind resembles the function of the “sorting hat” in J.K. Rowling’s *Harry Potter and the Sorcerer’s Stone*.<sup>6</sup> For Muggle readers who have no close relatives under the age of thirty, a quick review of the concept: Upon first entering Hogwarts, the special school for wizards-in-training, the new initiates are asked to place the sorting hat on their heads to determine to which of the school’s four houses the student will be assigned. Sometimes the hat decides quickly, while other times—not unlike IRS processing—considerable rumination appears to be required. But sooner or later, a decision is reached, and the hat announces that student’s house assignment—to his delight or dismay, as the case may be.

In our context, I see the IRS sorting hat declaring, in many cases, something like: “I know you were hoping for Gryffindor, but you’re a 527.”

There is actually some precedent for the exercise of IRS discretion of this sort. When it promulgated regulations for the new exempt category described in § 501(c)(10)—pertaining to “domestic fraternal societies . . . operating under the lodge system”—the IRS included the following statement at the conclusion of the regulation: “Any organization described in section 501(c)(7), such as, for example, a national college fraternity, is not described in section 501(c)(10) and this section.”<sup>7</sup> That was all; the IRS offered no explanation of why that conclusion was warranted, why it was sound, or why it was within the IRS’s authority. The conclusion was simply a flat statement: a § 501(c)(7) organization is not permitted to qualify under § 501(c)(10). Inferentially, this would be true even if the organization clearly meets all of the eligibility requirements for the latter category!

This somewhat bold assertion of “sorting hat” authority was tested, of course. But in *Zeta Beta Tau Fraternity, Inc. v. Commissioner*, 87 T.C. 421 (1987), the Tax Court upheld the validity of the regulation.<sup>8</sup> It was aided in reaching this conclusion by references in the statutory history that suggested Congress meant § 501(c)(10) status for organizations other than national college fraternities.<sup>9</sup> Based on this reasoning, one could then say that Congress also intended for political organizations to disclose the names of their donors and the amounts of their donations, thereby implicitly suggesting that a political organization should not be able to avoid these requirements simply

---

6. J. K. ROWLING, *HARRY POTTER AND THE SORCERER’S STONE* 113-130 (Arthur A. Levine ed., 1st ed. 1998).

7. Treas. Reg. § 1.501(c)(10)-1(a) (1972).

8. *Id.* at 434.

9. *Id.* at 429-32.

because the organization can be made to fit within the language of § 501(c)(4).

One objection to this “sorting hat” proposal is that organizations could then intentionally disqualify themselves for the category they prefer not to be placed in, thereby leaving the IRS with no choice but to allow the organization exemption under its preferred category. There are several responses to this objection.

First of all, it is not clear that an essentially political organization can easily disqualify itself from § 527 status. Not much is required to be a § 527 organization. The only obvious pathway for an organization seeking disqualification would be to declare that it is not “operated primarily for the purpose . . . of influenc[ing] the selection, nomination, election, or appointment of any individual to any . . . public office.”<sup>10</sup> But that determination would be a matter of fact, and one imagines that many political organizations—whether Tea Party affiliates or progressive organizations—would have difficulty proving that engaging in electoral activities was not their primary purpose.

But the IRS might have an even stronger hand than that suggests. It could say something like: “After reviewing the facts and circumstances, we conclude that your organization is a [fill in the blank: political organization, electrical cooperative, etc.] If you wish your organization to qualify for exempt status, you must satisfy the requirements of the appropriate section or paragraph describing your organization.” In other words, the IRS could say that the alternative is not simply to lapse into some other section that describes the organization less well, but rather to lapse into non-qualification altogether.

Could the IRS do this? Recall that the Tax Court denied Zeta Beta Tau qualification as a § 501(c)(10) organization, despite the fact that the fraternity did appear to meet the literal requirements of that paragraph.<sup>11</sup> The Tax Court did so to advance a clear legislative purpose; but the purpose of requiring political organizations to disclose donors and donations is no less clear.

Would the IRS do this, assuming that it could? Realistically, not in the current political climate, given that its political capital took a huge (though largely inappropriate) hit in the Tea Party pseudo-scandal of a few years ago. The IRS would probably not be willing to absorb the criticism it would receive if it adopted the proposal suggested here (which would probably require new regulations). But some actions the IRS cannot take immediately for political reasons do

---

10. I.R.C. § 527(e)(1), (2) (2012).

11. *Zeta Beta Tau*, 87 T.C. at 428, 435.

come to pass eventually, if the ideas are sufficiently aired at academic conferences. Perhaps this is such an idea.

An alternative to the “sorting hat” approach that might be more immediately palatable would be for the IRS to adopt a practice of approving exemption under particular categories as long as the organization does not seem to be pursuing that category of exemption for the purpose of avoiding clear legislative intent. The tax laws are full of rules that permit a taxpayer to engage in some favored activity, with the proviso that the purpose of doing so must not be a tax-avoidance purpose. Among the many examples is I.R.C. § 7872(d)(1)(B), which waives the imputation of interest in the case of certain below-market-rate loans, but only if the below-market-rate loan does not have tax avoidance as one of its principal purposes.

So if, as Mayer observes, organizations do sometimes seek exemption under a category as a means of either qualifying for a privilege or avoiding a restriction, under circumstances where it appears that clear congressional policy is being subverted, perhaps the IRS can just say no. I would hope that it would at least consider whether that could be possible, and when it would be appropriate to try.