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501(c)(3) Taxed on Political Activity, Warned about Asset Accumulation

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In another recent Technical Advice Memorandum (TAM), the IRS addressed a number of issues relating to the 501(c)(3) status of a religious organization and its subsidiaries. Most relevant to Community Action Agencies were its rulings that: (1) the organization's political activities warranted the imposition of an excise tax under section 4955 of the Internal Revenue Code, but not the revocation of its tax-exempt status; and (2) its subsidiaries' accumulation of assets, although substantial and controlled by the 501(c)(3)'s founder, just barely met the standard for establishing a charitable purpose for the accumulation, and therefore did not violate the prohibition on a substantial non-exempt purpose.[1]

Political Activities
The IRS found that statements by the 501(c)(3)'s founder, a minister, constituted impermissible intervention in a political campaign. During a nationally broadcast speech sponsored by the 501(c)(3), which was rebroadcast repeatedly, its founder stated that the audience should not vote for one of the major candidates for the president of the United States, saying that it would be dangerous to the country if the candidate were elected. He repeated similar statements in another broadcast and also stated that another elected official needed to be voted out of office. In neither speech did the founder issue a disclaimer indicating that the views were his own and not those of the 501(c)(3). After contact by the IRS, the founder eventually acknowledged that it was improper to mention the presidential candidate during the broadcast and the board of directors of the 501(c)(3) soon thereafter adopted a policy statement against political intervention. In concluding that the statements were impermissible political intervention, the IRS rejected the 501(c)(3)'s arguments that the statements were taken out of context and were not intended to endorse the candidate's political opponents or to influence listeners in how they voted. The IRS also rejected the 501(c)(3)'s argument that the minister's statements should be seen as his personal views, rather than that of the organization. The IRS held that where an official publication or program of the organization contains the offending statement, it should be imputed to the organization, particularly when it is made by its minister and no disclaimer of his representation of the organization's views was made.

The next step for the IRS was to determine the appropriate sanction against the 501(c)(3). The IRS noted that the Code's ban on political activity is absolute; unlike the restriction on lobbying, there is no *de minimis* exception. Moreover, the statements did not appear to be accidental or unintentional and were not promptly corrected. The IRS made clear that, in its view, Congress enacted the section 4955 excise tax not to replace revocation of the exempt status of a 501(c)(3) that engaged in political activities, but as an additional penalty. In this case, the IRS imposed a tax equal to 10 percent of each political expenditure on the 501(c)(3), as well as a 2.5 percent tax on the minister, as an organization manager. In addition, because the expenditures were not corrected within the required time period, the 501(c)(3) was liable for a 100 percent tax on the expenditures.

Perhaps the most interesting part of the ruling was the IRS's pass on revoking the organization's tax exemption. Despite its clear finding that the 501(c)(3) had impermissibly and unintentionally intervened in a political campaign, the IRS relied on legislative history to the Code and the preamble to the final section 4955 regulations to conclude that it had the discretion, where the facts and circumstances of an individual case warranted it, not to revoke the exemption where the penalty was disproportionate, such as where the expenditure was unintentional, of a small amount, and the organization subsequently adopted procedures to avoid such expenditures in the future. The IRS justified its decision on the basis that the offending statements constituted only two brief paragraphs of a two-hour broadcast and no other political statements had occurred during the three years at issue, as well as the fact that the 501(c)(3) had adopted a policy to prevent recurrences.

Asset Accumulation

Under the Code and its regulations, 501(c)(3)s many not have a substantial nonexempt purpose, i.e. a purpose that is not charitable, educational, etc. In some cases, the generation and accumulation of profits indicates a substantial nonexempt purpose. The section of the regulations that sets forth the rules for determining when accumulations of earnings and profits are necessary for the reasonably anticipated needs of a taxable business provides that, in order to justify such accumulation, the corporation must have:

> specific, definite and feasible plans for the use of such accumulation. Such an accumulation need not be used immediately, nor must the plans for its use be consummated with a short a period after the close of the taxable year, provided that such accumulation will be used within a reasonable time depending upon all the facts and circumstances relating to the future need of the business.[2]

For example, an organization's exemption was revoked where a closely-held religious organization accumulated over $5 million, while its exempt activities declined to a claimed $500,000 in expenditures per year, and there was nothing more concrete than the word of the charity's trustees as to the future use of the "sheer size" of the surplus.[3]

The ruling on asset accumulation is tied closely to the particular facts and circumstances at issue in the TAM, namely a for-profit subsidiary controlled by the 501(c)(3)'s founder and his family. The "closely-controlled" nature of the relationship caused the IRS to carefully scrutinize the activities of the 501(c)(3) and its subsidiary to determine if there was a substantial non-exempt purpose that threatened the tax-exempt status of the 501(c)(3). In this case, the IRS found it to be a close call, but ultimately found that the 501(c)(3) had provided sufficient information as to its needs and reasonable anticipated needs for its asset accumulations, such as covering deficits from operation of its tax-exempt programs. There was also some evidence that the 501(c)(3)'s investments in its subsidiary were designed to facilitate the planned expansion of the 501(c)(3)'s religious broadcasting activity.

The IRS strongly warned, however, at least in the case of organizations closely controlled by the founder and other insiders, a 501(c)(3) has a continuing obligation to translate its for-profit subsidiary's valuable assets into funds that can be used to further the 501(c)(3)'s exempt purposes, which may require selling some assets to an unrelated third party. In an interesting note, the IRS stated that the fact the assets are held in a for-profit company does not excuse the 501(c)(3), which controls the for-profit, from using the assets for charitable purposes. In supporting this statement, the TAM quoted from the following: [e]xcess accumulations maintained in a subsidiary entity under legal control of the exempt organization, but under the de facto control of the founder, are deemed to be for the founder's personal purposes if no exempt purpose is documented or implemented."[4] In sum, the IRS emphasized the need to take care that for-profit subsidiaries were not used to divert exempt organization assets, resources, and income to the founding families and other insiders.

Potential Impact on CAAs

The political activity portion of the TAM is of most relevance to CAAs. As seen by the ongoing examination by the IRS of a speech recently given by Julian Bond at the national convention of the NAACP, as well as audits of other 501(c)(3)s, statements that either expressly advocate support for or opposition to a candidate or party, or even (as in the case of the NAACP), indirectly doing so by criticizing the policies of an incumbent officeholder, may subject a 501(c)(3) to scrutiny. That is not to say that 501(c)(3)s should not speak out on policy issues, including critiques of current officeholders if appropriate. But the precise wording is important, and the outcome of an IRS review, if any, may be difficult to forecast.

The asset accumulation portion is likely to be of less relevance to CAAs. However, if there is undue insider control of the CAA, its assets, and its subsidiaries, to the insiders' private benefit, and a large discrepancy between the amount of accumulated assets and the funding of exempt charitable activities, the issue could be a problem for CAAs as well.

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[1] Technical Advice Memorandum 200437040 (June 7, 2004).
[2] Treas. Reg. (26 CFR) § 1.537-1(b)(1).
[3] Incorporated Trustees of Gospel Worker Soc'y v. United States, 510 F.Supp. 374 (D.D.C. 1981), aff'd, 672 F.2d 894 (D.C. Cir. 1981).
[4] Airlie Foundation v. United States, 826 F. Supp. 537, 551 (D.D.C. 1993), aff'd, 55 F.3d 684 (D.C. Cir. 1995).