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Restructuring governance and operations may reduce risks for politically active exempt organizations

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On Jan. 31, 2020, the Internal Revenue Service (IRS) released a private letter ruling (PLR) that startled many advisors of tax-exempt entities as a potentially significant deviation from prior guidance. PLR 202005020 ruled that the operation of a political action committee (2020 PAC) by the for-profit, corporate subsidiary (Corporate Sub) of a Section 501(c)(3) organization, the parent of a healthcare system (2020 Parent), would constitute participation or intervention in a political campaign by 2020 Parent. Section 501(c)(3) tax-exempt organizations are strictly prohibited from engaging in any political campaign activity. Therefore, if 2020 Parent had proceeded with the plan proposed in the ruling, then presumably the IRS would have revoked the organization's tax-exempt status.

The proposal in the ruling was for 2020 PAC to make expenditures to support or oppose candidates for public office and for this activity not to be attributed to 2020 Parent. However, the IRS ruled that the political campaign activity of a separately incorporated subsidiary (2020 PAC) would be attributed to its sole owner (2020 Parent). This is a relatively unusual and troubling finding because typically the activity of a for-profit subsidiary corporation is not attributed to its owner. For this reason, tax-exempt entities often use separately incorporated subsidiaries or affiliates to engage in activities that the tax-exempt entity could not engage in directly, such as lobbying or operating unrelated trades or businesses, confident that the subsidiary or affiliate's activities will not be attributed to the exempt entity. Various tax practitioners have spent a significant portion of 2020 musing whether PLR 202005020 calls this confidence into question.

In past rulings, such as PLR 201127013, released July 8, 2011, the IRS determined that a Section 501(c)(3) healthcare organization (2011 Parent) was not engaged in political campaign activity when it formed an affiliated Code Section 501(c)(4) social welfare organization (501(c)(4) Affiliate) that established and operated two PACs. The IRS did not attribute the activities of 501(c)(4) Affiliate, which included political activity due to the PACs, to 2011 Parent, even though a majority of the directors on 501(c)(4) Affiliate's board of directors were officers, directors or employees of 2011 Parent or other organizations related to 2011 Parent. In short, the IRS ruled in a situation superficially like PLR 202005020 that a separately incorporated affiliate of a Section 501(c)(3) organization could engage in political campaign activity without jeopardizing the Section 501(c)(3) organization's exempt status.

From all available indications, the requestor of the ruling in PLR 202005020 had talented and sophisticated legal and tax advisors. 2020 Parent represented that the separateness of each entity would be strictly observed. Each entity would carefully maintain separate bank accounts, books and records, financial statements, letterheads, and websites. Furthermore, 2020 Parent and Corporate Sub represented that they would enter into a resource-sharing agreement or cost sharing agreement to properly allocate the costs of all shared resources. Under such agreement, 2020 Parent would provide management, administrative and corporate services, as well as make available facilities and

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equipment, to Corporate Sub.[1] Pursuant to the cost sharing agreement, all such resources would be reimbursed at fair market value to avoid a situation where 2020 Parent subsidized Corporate Sub or 2020 PAC. Additionally, 2020 Parent's directors, officers and employees would track all time spent providing services to Corporate Sub or 2020 PAC so that the time would be appropriately allocated to Corporate Sub and reimbursed at fair market value. A very similar sounding cost sharing agreement met with IRS approval in PLR 201127013.

The IRS appears to have been particularly concerned about several facts unique to PLR 202005020, the sum of which may have contributed to the relatively unusual decision to attribute the activities of a corporate subsidiary to its parent:

- **Complete control over Corporate Sub director elections**: 2020 Parent, as sole shareholder of Corporate Sub, would be able to elect every one of Corporate Sub's directors, as well as remove any director with or without cause, giving 2020 Parent absolute control over Corporate Sub's governance.
- **Complete control over Corporate Sub officer elections**: 2020 Parent, as sole shareholder of Corporate Sub, would be able to elect or appoint every one of Corporate Sub's officers and assistant officers (or permit the directors of Corporate Sub to do so).
- **Corporate Sub controlled 2020 PAC's director and officer elections**: Corporate Sub would select the directors of 2020 PAC, who would select 2020 PAC's officers.
- **Provision of custom mailing list**: 2020 Parent would let Corporate Sub and 2020 PAC use the mailing lists of 2020 Parent employees in exchange for payment of fair market value.
- **Solicitation of employees**: Corporate Sub and 2020 PAC would solicit voluntary contributions to 2020 PAC from employees of 2020 Parent and affiliates of 2020 Parent. Employees of 2020 Parent would engage in and assist with such fundraising activities, in their capacities as service providers to Corporate Sub, under the cost sharing agreement.
- **Lack of any service providers at Corporate Sub or 2020 PAC**: Neither Corporate Sub nor 2020 PAC would have any employees who were not also employees of 2020 Parent.
- **Potential for director and officer overlap**: Directors and officers of 2020 PAC would be able serve concurrently as directors or officers of Corporate Sub and as directors, officers or employees of 2020 Parent with the potential for significant or full overlap.
- **2020 director, officer and employee services to Corporate Sub and 2020 PAC**: Although 2020 Parent would adopt a formal resolution prohibiting any director from involvement in 2020 PAC in an official capacity on behalf of 2020 Parent, directors, officers or employees of 2020 Parent could serve as directors, officers or service providers to Corporate Sub or 2020 PAC (just not in their formal 2020 Parent capacity).

In light of these and other relevant factors, the IRS specifically ruled that (i) 2020 Parent's provision of services and other resources to Corporate Sub and 2020 PAC and (ii) the creation and provision of a specialized mailing list to Corporate Sub and 2020 PAC would each constitute participation or intervention in a political campaign.

At first glance, the fact pattern in PLR 202005020 appears to be relatively common (a Section 501(c)(3) organization has subsidiaries or affiliates engaged in activities not appropriate for the Section 501(c)(3) organization to engage in directly). However, upon closer inspection, it may be an instance where the IRS grew concerned that the Section 501(c)(3) organization effectively had such total control over the actions of the corporate subsidiary that there was no meaningful separation between them. Several recommended best practices could help similarly situated tax-exempt entities avoid the same fate and ensure that the activities of subsidiaries and affiliates are not attributed to a related Section 501(c)(3) organization.

[1] The facilities that 2020 Parent would agree to provide include, but were not limited to, office space, telephones, information technology, furniture, office equipment (e.g., copiers and scanners), building maintenance, and cleaning services. The services 2020 Parent would provide include secretarial services, such as keeping statutory books and records and convening and documenting meetings of the boards of directors; safekeeping and filing all original corporate documents; establishing and managing financial accounts; collecting accounts payable and arranging for related dispute resolution; settling inter-company accounts within the health system operated by 2020 Parent; securing financing; procuring insurance; supervising the sale and purchase of assets; and tax and legal compliance services, which includes the preparation of tax returns and compliance with regulatory requirements to which Corporate Sub or a group member might be subject.

The following best practices show that there is some significant degree of daylight between affiliated, but separate entities:

- **Increase independent governance of corporate affiliate**: The IRS appeared troubled by the fact that 2020 Parent effectively had complete control over Corporate Sub's board of directors and officers. This concern could be avoided if the corporate affiliate had been formed as a nonprofit corporation with an independent board of directors, as opposed to a stock corporation that was 100 percent owned by the Section 501(c)(3) organization. A Section 501(c)(4) social welfare organization, the type approved in PLR 201127013, is a common choice for such a nonprofit corporation affiliate. There should be at least one (and, in ideal situations, more than one) independent director who is not affiliated with the Section 501(c)(3) organization (i.e., is not a director, officer or employee of the Section 501(c)(3) organization). Governance separation would be further enhanced by having a self-perpetuating board of directors for the affiliate (*i.e.*, a board of directors that elects its own successors), as opposed to a board of directors elected by the Section 501(c)(3) organization. Officers of the affiliate could be elected by the affiliate's independent board of directors, as opposed to being elected by the Section 501(c)(3) organization.

- **Retain independent service providers for affiliate and PAC**: The IRS seemed concerned with the fact that every one of the service providers for 2020 PAC would be directors, officers or employees of 2020 Parent (and other affiliates in the healthcare system). This potentially troubling situation could be avoided in at least two ways. First, in ideal situations, the affiliate and/or PAC could directly hire and employ service providers who were not directors, officers or employees of the Section 501(c)(3) related organization. Note that there would generally not be a problem if employees of a Section 501(c)(4) affiliate provided services to a Section 501(c)(3) organization at fair market value or less. It was only the reverse situation that the IRS may have found troubling in PLR 202005020 due to the prohibition on political campaign activity for Section 501(c)(3) organizations. Second, in situations where it is impractical or impossible for the affiliate or PAC to hire its own employees, the affiliate and/or PAC could retain consultants, government affairs firms and other independent contractors to carry out its key functions (especially, any functions relating to political campaign activity). With contractors carrying out sensitive functions, none of the directors, officers or employees of the Section 501(c)(3) organization would be directly engaged in political campaign activity.

- **Build out separate facilities and resources for affiliate and PAC**: If the affiliate and PAC had their own separate office space, information technology, office equipment and other resources necessary to carry on their activities, this would indicate further separation and potentially lead to lower risk of attribution of political activity. This step may be less essential because typically some sharing of these types of resources under a cost sharing agreement is permitted, if the affiliate reimburses the Section 501(c)(3) organization at fair market value for all resources used.

- **Avoid other aggressive fact patterns**: In PLR 202005020, the IRS may have been inclined to issue a negative ruling on the attribution of political campaign activity because 2020 Parent proposed engaging in an activity similar to that described in Situation 18, in Rev. Rul. 2007-41,[2] which has long been seen as indirect political campaign activity by a Section 501(c)(3) organization: providing a mailing list solely to one candidate or political action committee while declining to provide the mailing list to other committees or candidates. It is possible that the IRS would have reached the same decision with or without the provision of the 2020 Parent mailing list to Corporate Sub. However, such aggressive activities should be eliminated to avoid raising additional concerns, especially if a Section 501(c)(3) organization is unable to take conservative positions on the three factors discussed in the foregoing bullets.

These suggestions and recommendations are necessarily general in nature and may not avoid the risks presented by fact patterns like that seen in PLR 202005020. In situations where a Section 501(c)(3) organization would like to engage directly or indirectly in political campaign activity it should consult appropriate legal and tax-exempt organization counsel.

[2] Rev. Rul. 2007-41, Situation 18 discusses a Section 501(c)(3) theater organization that maintains a mailing list of its subscribers and contributors. The organization has never rented its mailing list to a third party, but after being approached by the campaign committee of a candidate for public office who supports increased funding for the arts, the organization agrees to rent its mailing list to the campaign committee for a fee that is comparable to fees charged by other similar organizations. The organization declines similar requests from campaign committees of other candidates. The IRS rules that organization has intervened indirectly in a political campaign.