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FROM DE FACTO TO STATUTORY EXEMPTION: AN
ANALYSIS OF THE EVOLUTION OF LEGISLATIVE POLICY
REGARDING THE FEDERAL TAXATION OF CAMPAIGN
FINANCE

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HOW should candidates, contributors, campaign organizations, and other political entities be taxed?¹ One would have expected this question to have been thoroughly debated and resolved prior to the legislation of any scheme of taxation, especially in view of the two vital and potentially conflicting interests at stake: (1) assuring a political process free from interference by the Internal Revenue Service (IRS), and (2) maintaining the flow of tax revenue and preventing the manipulation of the political process for the purpose of sheltering income. This article argues, however, that Congress never has confronted—or shown any inclination to consider—the fundamental question of the proper relationship between federal taxation and the political process.² Rather, for a long period Congress was content to engage in successive ad hoc accommodations with the IRS, with the objective of preserving a system of de facto tax exemption for campaign finance activities. When

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¹ Most campaign funds have been raised and expended through committees. Political committees generally fall within one of three categories: single-candidate committees; multi-candidate committees, including political action committees (PACs) organized by corporations and unions; and national, congressional, state, district, and local party committees. See generally 36 CONG. Q. WEEKLY REP. 718, 719-20 (1978). Recently, a multitude of committees have been created to serve two ethically questionable functions: (1) bypassing federal and state ceilings on amounts that an individual contributor can transfer to a candidate, and (2) obscuring information that must be disclosed to campaign finance regulatory bodies by overwhelming the agencies with documents. See D. ADAMANY & G. AGREE, POLITICAL MONEY 83-94 (1975); H. ALEXANDER, FINANCING THE 1972 ELECTION 12-19 (1976); CONGRESSIONAL QUARTERLY INC., II DOLLAR POLITICS 5-8 (1974) [hereinafter cited as II DOLLAR POLITICS]; Bicks & Friedman, *Regulation of Federal Election Finance: A Case of Misguided Morality*, 28 N.Y.U.L. REV. 975, 984-92 (1953).

² Similarly, commentators have focused almost exclusively on the technical aspects of this delicate relationship. See, e.g., Golden, *Federal Taxation and the Political Process*, 24 KAN. L. REV. 221 (1976); Kaplan, *Taxation and Political Campaigns: Interface Resolved*, 53 TAXES 340 (1975); Schaut, *Taxable Entities and Politics*, 52 TAXES 644 (1974); Streng, *The Federal Tax Treatment of Political Contributions and Political Organizations*, 29 TAX LAW. 139 (1975). For a discussion of the role of taxation in campaign finance from a broader and less technical perspective, see Boehm, *Taxes and Politics*, 22 TAX L. REV. 369 (1967).

informal ad hoc agreements finally became unworkable in the early 1970's, Congress hastily transformed the de facto tax exemption into a more permanent statutory exemption of the political process. But ironically, while the current statutory scheme³ ostensibly exempts many contributors and political organizations from taxation, it actually invites vast new IRS involvement in the political process. This result presents a striking contrast to the noninterference historically cultivated by Congress.

This article first explores the development of the de facto system of tax exemption and identifies the tensions that led to its demise. The analysis then details the substitution of a statutory structure in place of the traditional informal arrangement and examines the potential present in that structure for substantial IRS interference in the political process.

I. THE DE FACTO SYSTEM OF TAX EXEMPTION

A full understanding of the current statutory structure requires an appreciation of Congress's historical aversion to any tax legislation that would affect adversely the political process. For decades one overriding concern has guided Congress: assuring a maximum, unfettered flow of campaign funds. Despite occasional pronouncements advocating reform,⁴ the legislative branch has shown little

³ The term "scheme" is rather a misnomer because although several scattered Internal Revenue Code sections deal with particular aspects of campaign finance, no coordinated regime of taxation exists. The most prominent provision, I.R.C. § 527, exempts qualifying organizations from income taxation, but the standards for qualification are vague and remain largely within IRS discretion. See text accompanying notes 130-41 *infra*. Similarly, although I.R.C. § 2501(a)(5) exempts transfers to political organizations from gift tax, the meaning of the term "political organization" is unsettled. Adding to the uncertainty, several sections use the expression "political party," I.R.C. §§ 271, 276, which may have a different meaning than the term "political organization." Compare I.R.C. § 271(h)(1) with *id.* § 527(e)(1). I.R.C. § 41 provides a limited credit for political contributions. See text accompanying notes 126-30 *infra*. Finally, I.R.C. § 9006(a), in combination with § 6096(a), provides campaign funding for qualifying Presidential and Vice Presidential candidates through a one dollar check-off option on personal income tax forms.

In contrast to these benefits, I.R.C. § 84 treats the contribution of property with a fair market value exceeding the property's adjusted basis as a taxable sale. See text accompanying notes 122-29 *infra*. I.R.C. § 271 disallows the bad debt deduction normally available under § 166 if the debt is owed by a political party. See text accompanying notes 26-31 *infra*. Similarly, I.R.C. § 276 denies deductions for advertisements in political journals and for tickets to entertainment events in cases in which the proceeds benefit a political party or candidate. See text accompanying notes 32-34 *infra*.

⁴ Legislative pronouncements supporting campaign finance reform rarely lead to effective remedial action. See H. ALEXANDER, MONEY IN POLITICS 198-229 (1972). For a particularly

initiative in eliminating tax abuse or in closing tax loopholes in the campaign finance area. Indeed, Congress has acted only under intense public pressure or in response to abrupt changes in IRS policy. In contrast, the legislature has not hesitated to use taxation to increase the supply of campaign funds.⁵

A. Phase I: 1913-1952

For nearly forty years, from the enactment of the first modern income tax laws in 1913 until 1952,⁶ Congress ignored the issue of the proper tax treatment of the individuals and organizations financing the electoral process. Legislative neglect of the campaign finance system is illustrated by Congress's treatment of four aspects of campaign funding: (1) income of political organizations, (2) loans made to campaign committees, (3) advertising in party publications, and (4) gifts of appreciated property.

During this period, the Internal Revenue Code made no reference to the income taxation of candidates, campaign committees, full-fledged political organizations, or any other political groups. Under the traditional inclusive definition of taxable income, any income attributable to these putative taxpayers should have been subject

cynical, Marxist view of the "politics" of campaign reform, see D. NICHOLS, *FINANCING ELECTIONS* 150-53 (1974).

⁵ A number of Internal Revenue Code provisions were designed to stimulate campaign funding. See I.R.C. §§ 41, 218 (affording an income tax credit or deduction to contributors); *id.* § 527(g) (exempting candidates' and elected officials' newsletter funds and permitting credits and deductions for contributions to such funds); *id.* §§ 9001-9042 (establishing a fund to distribute to Presidential campaigns money collected through a check-off option on individual tax returns). See generally Comment, *Tax Subsidies for Political Participation*, 31 *TAX LAW* 461 (1978).

Apparently, the credit and deduction provisions, however, have not stimulated political contributions to any appreciable degree. As one noted authority recently has concluded, "the evidence suggests that both credit and deduction are simply irrelevant to their stated purpose." Adamany, *The Failure of Tax Incentives for Political Giving*, 7 *TAX NOTES* 3, 4 (1978). The Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, repealed the deduction. Although the check-off system seems to have attracted somewhat broader participation from all income groups, this conclusion must be tested over a longer period of time. Adamany, *supra*, at 5.

⁶ The sixteenth amendment, permitting Congress "to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration," became effective on February 25, 1913. U.S. CONST. amend. XVI. See also B. BITTKER & L. STONE, *FEDERAL INCOME, ESTATE AND GIFT TAXATION* 3 (4th ed. 1972). Shortly thereafter, Congress enacted the 1913 Income Tax, which made no reference to the income taxation of campaign finance. The gift tax, which has been in continuous effect in various forms since 1924, also fails to address the matter. See generally R. PAUL, *II FEDERAL ESTATE AND GIFT TAXATION* § 15.01 (1942); S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, *I FEDERAL INCOME TAXATION* 8-11 (1972) [hereinafter cited as *I FEDERAL INCOME TAXATION*].

to taxation.⁷ Such income could take any of a number of forms. A political organization endowed with a surplus after a campaign might earn income by investing contributions or realize capital gain by selling contributed property.⁸ Although classifying a political organization as a particular type of entity for tax purposes might have presented substantial difficulties,⁹ the taxable status of an

⁷ I.R.C. § 61(a) states: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived . . ." In the landmark case *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), the Supreme Court interpreted the scope of § 22(a), the predecessor of § 61(a) under the Internal Revenue Code of 1939, as being as broad as Congress's taxing power, rejecting the contention that the punitive damages portion of an antitrust recovery is not includable in gross income.

Of course, no taxation question would have arisen if political organizations had been specifically exempted from taxation. Statutory exemption, however, did not exist until Congress enacted the Act of Jan. 3, 1975, Pub. L. No. 93-625, § 10(a), 88 Stat. 2108 (current version at I.R.C. § 527) [hereinafter referred to as the Upholstery Regulators Act], expressly exempting political organizations from income taxation on certain receipts.

Alternatively, if classified as gifts for income tax purposes, political contributions would be excluded from the gross income of the donee pursuant to I.R.C. § 102. Whether a receipt qualifies as a gift depends upon whether the transfer to the donee is made out of "detached and disinterested generosity." See *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960) (quoting *Commissioner v. LaBue*, 351 U.S. 243, 246 (1956)). Cf. *Olk v. United States*, 536 F.2d 876, 879 (9th Cir. 1976), *cert. denied*, 429 U.S. 920 (1977) (tokens received by casino craps dealer given not out of 'detached and disinterested generosity,' but rather as a "[t]ribute to the gods of fortune which it is hoped will be returned bounteously . . ."). *But see Stratton v. Commissioner*, 54 T.C. 255, 281 (1970), *acq. and nonacq. on other grounds* 1970-2 C.B. xxi, xxii (establishing that transfers to former Illinois Governor William Stratton, although not campaign contributions, were intended for his unrestricted personal use and therefore were excludable from income under I.R.C. § 102 as a nontaxable gift).

⁸ *But see Rogovin, Revenuers vs. Republicans*, THE NEW REPUBLIC, July 7, 1973, at 16, 18. After the 1968 Presidential election the Republican Finance Committee had a \$1.8 million surplus, which was placed in safe-deposit boxes rather than invested. Apparently the committee sought to avoid filing a Fiduciary Income Tax Return, which the IRS had suggested might be required for investment income of political organizations. See notes 46-48 *infra* and accompanying text.

⁹ Whether a political organization is classified as an association or a trust has major income tax consequences for the organization. Associations generally are treated as corporations, I.R.C. § 7701(a)(3), while trusts normally are subject to the provisions governing individuals, I.R.C. § 641(a). As a result, associations receive the benefit of the historically lower corporate income tax rate. The Revenue Act of 1978 will exacerbate this disparity in the treatment of associations and trusts. Compare I.R.C. § 1(e), as amended by Revenue Act of 1978, Pub. L. No. 95-600, § 101(a), 92 Stat. 2763, with I.R.C. § 11, as amended by Revenue Act of 1978, Pub. L. No. 95-600, § 301, 92 Stat. 2763.

I.R.C. § 527 treats political organizations as associations, with certain modifications. See notes 94-104 *infra* and accompanying text. In contrast, shortly before the enactment of § 527, the IRS had proposed to tax political organizations as corporations, and candidates' segregated campaign funds as trusts. See *Rov. Rul. 74-23*, 1974-1 C.B. 17; *Rev. Rul. 74-21*, 1974-1 C.B. 14. This dual approach departed from an earlier IRS position that permitted political committees, but not segregated funds, to report on a Fiduciary Income Tax Return income

organization's income should have been beyond question. Nonetheless, the Service treated such income as functionally tax exempt.¹⁰ Moreover, the IRS made no serious effort to tax contributions, although contributions, as well as income earned from them, were susceptible to taxation under a number of theories.¹¹

The precise motivation behind IRS policy and congressional inertia during this period remains unclear. Quite plausibly it was the outgrowth of an implicit *modus vivendi* between the Service and Congress: perhaps the Service was anxious to avoid auditing those who control IRS purse strings and Congress found *de facto* tax exemption a benefit much too attractive to eliminate. Whatever the motivation, the outcome was clear. The IRS policy of nonenforcement, coupled with congressional lassitude, effectively exempted most campaign finance from income taxation.¹²

earned on bank accounts containing unexpended contributions. Rev. Proc. 68-19, 1968-1 C.B. 810, 811.

The classification difficulties arise primarily because political organizations do not fall neatly within either category—trust or association. Unlike the typical trust, few political organizations comply with trust formalities or aim to preserve a corpus for beneficiaries. See Treas. Reg. § 301.7701-4 (1967). Likewise, political organizations rarely incorporate or carry on business for profit, an essential attribute of all taxable associations. See Streng, *supra* note 2, at 154-57; Tannenbaum, *Taxation of Political Campaign Committees and Political Parties*, in TAXATION WITH REPRESENTATION, THE TAX TREATMENT OF POLITICAL CONTRIBUTIONS AND GROUPS at 72-526 (1972); Note, *Campaign Financing and Democracy: Limiting Tax Benefits for the Affluent Contributor*, 59 IOWA L. REV. 323, 330-33 (1973).

¹⁰ In enforcing the income tax laws the IRS has distinguished, however, between legitimate fundraising groups and organizations formed merely to exploit the tax benefits afforded political groups. The Service never has hesitated to include contributions "diverted from the channel of campaign activity and used by the political candidate for any personal purpose" in the candidate's gross income. Rev. Proc. 68-19, 1968-1 C.B. 810. See also Rev. Rul. 54-80, 1954-1 C.B. 11; I.T. 3276, 1939-1 C.B. (pt. 1) 108. Courts have endorsed the Service's position and have placed on the candidate the burden of establishing the propriety of expenditures. See, e.g., *United States v. Jett*, 352 F.2d 179 (6th Cir. 1965), *cert. denied*, 383 U.S. 935 (1966); *O'Dwyer v. Commissioner*, 266 F.2d 575 (4th Cir.), *cert. denied*, 361 U.S. 862 (1959); *Reichert v. Commissioner*, 19 T.C. 1027 (1953).

¹¹ See note 7 *supra*.

¹² The IRS does have at least a tradition of enforcement with regard to the gift tax. See Rev. Rul. 59-57, 1959-1 C.B. 626 (conclusory statement that political contributions are subject to gift tax). Although Rev. Rul. 72-355, 1972-2 C.B. 532, indicated that the Service's policy of enforcing the gift tax on political contributions was traceable to the 1932 enactment of the current gift tax, one commentator has asserted that this position was at best informal until 1956. See Streng, *supra* note 2, at 172, 183. The Tax Court recently supported Professor Streng's view in *Carson v. Commissioner*, 71 T.C. 252 (1978):

From 1924, when the gift tax was first enacted, until 1959, the Service issued no regulations or rulings indicating that campaign contributions were subject to the gift tax. It was not until 1959 that [the IRS] issued a revenue ruling simply declaring, without the benefit of any analysis, that campaign contributions are subject to the gift

The IRS assumed a similar nonenforcement posture regarding loans made to campaign organizations. Major contributors typically made substantial unsecured "loans" to candidates, never intending that the loans be repaid.¹³ The Service should have questioned whether these contributions were genuine loans for adequate consideration, and in cases in which the payments were not bona fide loans, whether the contributor was subject to gift tax or the candidate to income tax.¹⁴ Without confronting these basic tax questions, the IRS accepted characterizations of the contributions as loans¹⁵—despite persuasive evidence that such characterizations were unwarranted. When these loans were dishonored, each contributor claimed a bad debt deduction, thus reducing the cost of the contribution.¹⁶ High bracket taxpayers were presented with major

tax The absence of any decided cases on the point during this long period of time also demonstrates that [the IRS] was not administratively applying the gift tax to campaign contributions.

Id. at 147 (footnote omitted). For an analysis of *Carson*, see Schoenblum, *The Changing Meaning of "Gift": An Analysis of the Tax Court's Decision in Carson v. Commissioner*, 32 VAND. L. REV. 641 (1979).

¹³ For a more complete discussion of this practice, see Bloom, *Tax Results of Political Contributions*, 36 B.U.L. REV. 170, 175 (1956); Boehm, *supra* note 2, at 388-96.

¹⁴ The principle that a bad debt deduction can be claimed only for a bona fide debt and not for what is essentially an advance, gift, or contribution to capital is well-established outside the campaign finance context. *See, e.g.*, *Alexander & Baldwin v. Kanne*, 190 F.2d 153 (9th Cir. 1951) (holding funds a capital contribution, considering the absence of true debtor-creditor relationship necessary for debt to be deductible); *Du Pont v. Commissioner*, 36 B.T.A. 223 (1937) (holding payments an advance, because repayment not expected); *Grossman v. Commissioner*, 9 B.T.A. 643 (1927) (holding money a gift, based on presumption that a transfer from parent to child is either a gift or an advance).

In one case the IRS did challenge a bad debt deduction for money advanced to a campaign committee for George Peddy, the losing candidate for United States Senator from Texas in 1922. The taxpayer was to be repaid out of later contributions, funds that never materialized. The Board of Tax Appeals found the debt invalid because the committee never had agreed to assume personal liability on the obligation. *Cullinan v. Commissioner*, 19 B.T.A. 930, 932 (1930). The *Cullinan* decision merely ensured that contributors would take promissory notes and otherwise observe the formalities associated with debt obligations. *See* notes 26-31 *infra* and accompanying text.

¹⁵ Often the lender received a nonrecourse obligation in exchange for his loan and entertained no serious expectation of repayment. For example, in 1940 Marshall Field, the prominent Chicago financier, "loaned" the New York State Democratic Committee \$50,000. In 1948 the committee informed Field that there would be no payments made on the promissory note. He finally received 10 cents on the dollar as part of a general settlement with the other major creditors of the committee. *See* Letter from Deputy Commissioner E.I. McLarney to Marshall Field (May 18, 1949), *reprinted in* 98 CONG. REC. 4544 (1952) (approving the claim of a bad debt deduction).

¹⁶ The bad debt deduction was taken under § 23(k)(1) of the 1939 Code. Int. Rev. Code of 1939, ch. 1, § 23(k)(1), 53 Stat. 1 (current version at I.R.C. § 166).

incentives to finance campaigns, for in many cases contributors incurred a net cost as low as 10%¹⁷ and avoided entirely the gift tax payable on political contributions.

For many years contributors benefited from an advertising loophole as well as from this treatment of campaign loans. The Tillman Act¹⁸ prohibited corporations from contributing directly to political campaigns.¹⁹ To bypass this restriction and simultaneously to derive

¹⁷ Without the deduction, a \$40,000 contribution would cost the contributor the full \$40,000. With the deduction, a taxpayer in the 90% bracket would enjoy a tax savings of \$36,000, reducing the net cost of the contribution to \$4,000. The example is not farfetched: a marginal rate hovering around 90% was the rule during the 1940's and early 1950's for taxable income exceeding \$200,000. See J. MERTENS, I THE LAW OF FEDERAL INCOME TAXATION § 2.03 (rev. ed. 1974).

¹⁸ Tillman Act of 1907, ch. 420, 34 Stat. 864 (current version at 2 U.S.C. § 441b (1976)).

¹⁹ This prohibition arose from populist sentiment against corporations suspected of making substantial contributions to elected officials who "were basically on the payrolls of these various large corporations." Weiss, *Federal Tax Reform—The Need for Change in the Financing of Political Campaigns*, 61 NAT'L TAX ASSOC. PROC. 470, 474-75 (1968). Notorious robber baron Mark Hanna reportedly established an industry-by-industry system of exactions, distributing the funds to select candidates. See G. THAYER, WHO SHAKES THE MONEY TREE? 48-52 (1973). Richard Nixon's personal attorney, Herbert Kalmbach, apparently handled a variation of this scheme in the 1972 Presidential campaign. See II DOLLAR POLITICS, *supra* note 1, at 65.

The Federal Corrupt Practices Act, ch. 368, tit. III, § 313, 43 Stat. 1070 (1925) (repealed 1972), broadened the Tillman Act prohibition in two significant ways: the statute used the term "contribution" rather than "money contribution," and penalties were extended to the recipients of contributions as well as to the donors.

In 1943 Congress extended the Federal Corrupt Practices Act provision to include labor unions, War Labor Disputes Act, ch. 144, § 9, 57 Stat. 163 (1943) (amending Federal Corrupt Practices Act, ch. 368, tit. III, § 313, 43 Stat. 1070 (1925)), largely a reaction to massive C.I.O. expenditures in a particular campaign. Weiss, *supra*, at 474-75. Congress later incorporated this temporary wartime measure into the Labor Management Relations Act (Taft-Hartley Act), ch. 120, § 304, 61 Stat. 136 (1947) (amending Federal Corrupt Practices Act, ch. 368, tit. III, § 313, 43 Stat. 1070 (1925)) (repealed 1972).

The broad prohibition against corporate and union contributions was repealed with the enactment of the Federal Election Campaign Act of 1971, Pub. L. No. 92-225, § 405, 86 Stat. 3 (1972) (repealing Federal Corrupt Practices Act, ch. 368, tit. III, § 313, 43 Stat. 1070 (1925)) (repealed 1976). Congress retained the prohibition against "contributions or expenditures," but excluded from the definition of contributions and expenditures communications by corporations to shareholders and their families and by labor organizations to members and their families soliciting individual contributions. The Act also permitted expenditures for the establishment and administration of segregated funds and for soliciting contributions, as well as for "nonpartisan" registration campaigns directed at shareholders, union members, and their families. *Id.* § 205. See generally Sproul, *A Primer for Corporate and Union Political Action Committees* (pt. 1), 24 PRAC. LAW, no. 5, at 39 (1978); Comment, *Corporate Political Action Committees: Effect of the Federal Election Campaign Act Amendments of 1976*, 26 CATH. U.L. REV. 756 (1977); Comment, *The Constitutionality of the Federal Ban on Corporate and Union Campaign Contributions and Expenditures*, 42 U. CHI. L. REV. 148 (1974); Note, *Corporate and Union Political Contributions and Expenditures Under*

tax benefits, businesses purchased "advertisements" in political party journals and national convention programs.²⁰ Once classified as advertising expenditures, these payments could be deducted as business expenses although they simply represented an indirect way of making corporate contributions at a reduced cost.²¹ Despite common knowledge of the practice, neither Congress nor the IRS took steps to eliminate it.

The de facto tax exemption of political organizations gave the contribution of appreciated property an appeal distinct from that

2 U.S.C. § 441b: A Constitutional Analysis, 21 UTAH L. REV. 291, 292-302 (1977).

Recently, the Supreme Court considered a state law prohibiting a corporation from making expenditures to publicize its views on a referendum proposal. See *First Nat'l Bank v. Bellotti*, 435 U.S. 765 (1978). In that case, the Court held that the restriction unconstitutionally interfered with the corporation's exercise of its first amendment rights. The Court expressly distinguished the Federal Corrupt Practices Act, however, emphasizing that the "consideration of a corporation's right to speak on issues of general public interest implies no comparable right in the quite different context of participation in a political campaign for election to public office." *Id.* at 788 n.26.

The Federal Election Campaign Act provisions have spurred the development of PACs: by 1976, 450 corporate PACs were registered with the Federal Election Commission. See *N.Y. Times*, Feb. 15, 1977, § L, at 1, col. 4. The Federal Election Commission's favorable attitude also has contributed to this proliferation. See, e.g., *FEC Adv. Op.* 1975-23, 40 Fed. Reg. 56,584 (1975), in which the Commission approved a Sun Oil Company proposal to use general funds to establish, administer, and solicit voluntary contributions for a PAC. On the day of the Sun Oil decision, 137 corporate PACs registered with the Commission. See *Boggs, PACs: Business Political Renaissance*, 14 TRIAL, no. 1, at 5-6 (1978). Prohibited from making direct contributions, corporations and unions establish PACs and solicit donations from shareholders, employees, and their families. PACs distribute the funds to candidates, subject to ceilings placed on contribution size. In 1976 general elections, for example, corporate and business trade PACs contributed \$6.9 million, and labor PACs \$8.1 million, to congressional candidates. For a current, astute analysis of PAC activity, see 36 CONG. Q. WEEKLY REP. 849 (1978).

²⁰ In 1936 the Democratic Party received \$250,000 from advertisements sold at \$2,500 per page in *Book of the Democratic Convention of 1936*. G. THAYER, *supra* note 19, at 71. By 1966 the price per page had risen 600% to \$15,000. See note 33 *infra*.

²¹ During the 1950's a series of court decisions and IRS rulings recognized the deductibility of expenditures on political journal advertisements, but only in limited circumstances. See, e.g., *Denise Coal Co. v. Commissioner*, 29 T.C. 528 (1957), *aff'd in part and rev'd in part*, 271 F.2d 930 (3d Cir. 1959), *acq.* 1958-2 C.B. 5 (permitting deduction for payments for legitimate advertising in the 1948 Democratic National Convention program; finding no evidence of a disguised contribution). *Accord*, *Wolkowitz v. Commissioner*, 8 T.C.M. (CCH) 754,768 (1949) (finding advertisement in local New Jersey political club's dance program placed "in good faith with the expectation of results similar to those derived from advertising in other mediums").

The Service has established a parallel line of authority. See, e.g., *Rev. Rul.* 56-343, 1956-2 C.B. 115 (holding expenditures for advertisements in national political convention programs deductible as ordinary and necessary business expenses pursuant to I.R.C. § 162(a) if expenditures are reasonable in amount, bear a direct relation to the advertiser's business, and do not exceed the value of the advertising space acquired).

of loans and advertising.²² A contributor could donate the equivalent of a cash contribution in highly appreciated property having a low basis. The contributor would treat the transaction as a gift,²³ avoiding income tax on the appreciation because the transaction did not qualify as a sale or exchange. Although as donee the political organization would have to take the contributor's basis in the property, the tax-exempt status of the organization meant that the donee would realize no gain when it disposed of the property for cash. Using this technique, a campaign contributor could make a contribution at a substantial tax saving,²⁴ while the political organization obtained and sold tax-free property more valuable than any contribution the organization otherwise might have received from the same donor. Several million dollars of capital gain obviously were escaping untaxed,²⁵ but Congress took no action and the Service continued to recognize the tax-exempt status of political organizations.

B. Phase II: 1952-1967

In the period between 1952 and 1967, the de facto system of tax exemption remained largely intact. Congress was compelled to act, however, on two distinct occasions—to close first the campaign loan loophole and later the advertising loophole. In each case dramatic public disclosures, accompanied by the efforts of a single Senator, triggered the legislative reform. This legislative activity, however,

²² Appreciated property is property that has increased in value since its acquisition. Upon the disposition of appreciated property, the taxpayer ordinarily would be taxed on the gain realized, *i.e.*, the difference between the original cost of acquiring the property, with certain adjustments, and the value of cash and property received upon its disposition. See I.R.C. §§ 1001(a), 1011, 1012.

²³ On transfers classified as gifts, the taxpayer could claim an annual exclusion of \$3,000 per donee, see I.R.C. § 2503(b), as well as a \$30,000 lifetime exemption, Int. Rev. Code of 1954, ch. 736, § 2521, 68A Stat. 410 (repealed 1976)(effective for gifts made prior to Jan. 1, 1977). The Tax Reform Act of 1976 substituted for the \$30,000 lifetime exemption a unified gift-estate tax credit that will reach \$47,000 by 1981. I.R.C. § 2505(a)-(b). This is roughly equivalent to a \$175,000 exemption.

²⁴ A contributor planning to donate \$20,000 to a political organization might own, for example, a rapidly appreciating capital asset that he had purchased at \$5,000 and that is currently worth \$20,000. If he contributed the cash proceeds from a sale of the asset, he might pay a tax close to \$7,000 on the sale, taking into account capital gains tax and various tax preferences. In addition, he would be liable for gift tax on the transfer of the cash. By making a gift of the property itself, he would avoid the income tax incurred on a sale, although he might be liable for gift tax on the transfer.

²⁵ Transfers of appreciated property to political organizations cost the Treasury approximately \$5 million in revenue during the 1972 election year. 119 CONG. REC. 27469 (1973).

responded directly to particular well-publicized examples of tax abuse and did not entail any comprehensive review of the proper relationship between the tax laws and the political process.

During the 1952 Presidential campaign, while the Democratic Party still controlled the executive branch of government, intimations of IRS sleight of hand in the issuance of certain private letter rulings surfaced. These suggestions erupted into a major embarrassment when Republican Senator John Williams questioned the propriety of the rulings on the floor of the Senate.²⁶ Issued to three prominent Democratic Party contributors—Richard G. Reynolds,²⁷ Marshall Field,²⁸ and David Schulte²⁹—the rulings provided that the substantial uncollected “loans” the three had made to the Democratic Party would not be deemed taxable gifts and could be deducted as bad debts. Senator Williams was openly attacking the well-established practice of denominating campaign contributions as loans. The Senator not only questioned the bona fide nature of the loans, but also detailed the rather dubious procedural aspects of one of the rulings. This ruling had been “issued less than 48 hours after the application was received in Washington. . . . [C]ertain

²⁶ 98 CONG. REC. 4543-44 (1952). Senator Williams apparently recalled that less than two years earlier, in a ruling issued on September 22, 1950, the IRS had denied deductions to purchasers of tickets to a Republican Party dinner. See Boehm, *supra* note 2, at 389 n.79.

²⁷ On December 28, 1948, Reynolds, of the Reynolds tobacco empire, sought a ruling regarding the deductibility of the unrepaid portion of loans that he had made to the Democratic State Committee of New York. Reynolds had received three demand notes in amounts totaling \$270,000 from the New York committee. The ruling request indicated that the notes had been issued with expectation of repayment in annual installments, that unsuccessful demands for repayment had been made, and that the committee had insufficient assets to repay the amounts owed. The committee had offered Reynolds a settlement at the rate of 10 cents on the dollar.

On December 30, 1948—one day before the close of the calendar tax year and less than 48 hours after the submission of the ruling request—E.I. McLarney, deputy commissioner of the IRS, personally indicated to Reynolds that the difference between the “loan” and the proceeds from the settlement would be deductible as a nonbusiness bad debt. See 98 CONG. REC. 4543-45 (1952).

²⁸ In 1940 Field made a \$50,000 loan to the New York State Democratic Committee, receiving a promissory note in exchange. As part of the settlement with Reynolds, the committee offered Field 10 cents on the dollar. Deputy Commissioner McLarney determined that the unrepaid portion of Field’s “loan” also was deductible. *Id.*

²⁹ Schulte, described as a “New York tycoon,” Boehm, *supra* note 2, at 389, had advanced \$50,000 to the New York committee during the 1944 campaign with the understanding that the committee would repay the advance gradually, as funds became available after the campaign. Schulte never received any repayment, and in 1948 he was asked to accept the same settlement offer that was made to Reynolds and Field. The IRS also approved Schulte’s claim of a bad debt deduction for the unrepaid portion of the advance. 98 CONG. REC. 4583 (1952).

officials in the [IRS could] recollect a conference having been held relative to this decision, but so far they [had] been unable to find any minutes of such conference, nor [could] anyone remember who participated"³⁰

During the same period, Senator Williams introduced and lobbied for a bill to prohibit bad debt deductions for unrepaid loans to political candidates and organizations. Against a background of the public attention generated by Williams' exposé, the lack of persuasive explanations for the rulings, and the Republican congressional majority's desire to embarrass the Democratic Party during an election year, the Williams proposal finally was enacted despite some stiff initial opposition.³¹ Although Senator Williams' bill closed one avenue of tax avoidance, the bill was a particularized response motivated largely by partisan concerns. Congress made no attempt to confront other areas of abuse or the more fundamental question of the proper role of taxation in the political system. As a result, a trifurcated system was in operation following the enactment of the Williams legislation: a statutory taxation scheme that did not exempt expressly the income of political organizations; a de facto arrangement that not only exempted such income, but also tolerated specious deductions for contributors; and a statutory provision barring one of these sham deductions while ignoring the others.

In 1966³² a second abuse attracted widespread public attention, shaking the traditional accommodation between Congress and the Service once more. Senator Williams again led the reform effort, this time against corporations that were claiming deductions for advertising in party publications. The technique had become so popular that corporations were paying as much as \$15,000 per page to advertise in party journals.³³ Repeating the strategy used success-

³⁰ 98 CONG. REC. 4543 (1952).

³¹ During May of 1952, Senator Williams proposed a number of bills to curtail bad debt deductions for what were essentially contributions. He met resistance in both the Senate Finance Committee and the House Committee on Ways and Means. Following reports that the House committee planned no action during 1952, Williams managed to bring his bill to the floor of the Senate. *Id.* at 8279. Congress enacted the measure shortly thereafter. Legislative Branch Appropriation Act of 1953, ch. 598, 66 Stat. 464 (1952) (amending I.R.C. § 23(k)(6)) (current version at I.R.C. § 271). See Boehm, *supra* note 2, at 393.

³² Between 1952 and 1966, the Service's principal campaign finance concern was curtailing candidates' personal use of funds contributed to campaign organizations. See note 10 *supra*.

³³ Boehm, *supra* note 2, at 396. For example, the Democratic State Committees on Voter Education published *Toward an Age of Greatness*, a flashy magazine of 178 pages. The magazine contained laudatory articles on the current administration's personnel, as well as

fully in the political loan disclosures scandal, Senator Williams questioned on the floor of the Senate the propriety of these disguised corporate contributions. After public exposure of the suspicious expenditures, legislation to prohibit tax deductions for advertisements in party publications passed both houses of Congress with little opposition.³⁴ Congress again failed, however, to consider any comprehensive scheme for the taxation of campaign finance activities.

C. Phase III: 1967-1974

By 1967 the de facto income tax exemption for political candidates, organizations, and contributors had survived for more than

68 full-page advertisements. A one page advertisement sold for \$15,000, as compared with \$5,000 for a comparable page in *Time*. In terms of readership, the advertiser was spending \$60 per thousand readers, as compared to \$5 per thousand readers for a *Time* advertisement. Not surprisingly, many of the advertisers were government contractors. 112 CONG. REC. 1237-40 (1966).

Not only the Democrats charged exorbitant rates for advertisements appearing in political party journals. In 1964 the Republican Party published *Congress—The Heartbeat of Government*, charging \$10,000 per advertising page. By the time a second edition appeared in 1966, the advertising rate had increased to \$15,000 per page. See Boehm, *supra* note 2, at 397 n.93. See also Pence, *Financing Our Parties*, THE REPORTER, Feb. 10, 1966, at 29, 33.

³⁴ Senator Williams minced no words, specifically charging that the *Toward an Age of Greatness* concept was a "shakedown" of corporations with government contracts. 112 CONG. REC. 1237 (1966). The amendment was enacted within two months of its proposal. Tax Adjustment Act of 1966, Pub. L. No. 89-368, § 301, 80 Stat. 38 (current version at I.R.C. § 276(b)(1)). This second Williams amendment disallowed deductions for advertising in convention programs and other political publications in cases in which the proceeds would benefit a party or a candidate. Proceeds from admission to dinners, programs, or inaugural events also would be nondeductible if they benefited a party or a candidate. Even when an advertiser could establish an expectation of significant business benefit, nondeductibility would remain the rule. See S. REP. No. 1010, 89th Cong., 2d Sess. 40-41, reprinted in [1966] U.S. CODE CONG. & AD. NEWS 1985, 2016-18.

In June of 1968, just a few months before the national elections, Congress amended the statute again to permit deductions for advertisements in convention programs. Act of June 18, 1968, Pub. L. No. 90-346, 82 Stat. 183. The deduction, however, was available only to the extent that the funds were used to defray the costs of a convention to nominate a Presidential and Vice-Presidential candidate. Although ostensibly a restrictive provision, the amendment afforded significant benefits: funds that ordinarily would have defrayed convention expenses could be used elsewhere. See Weiss, *supra* note 19, at 474. Moreover, the law permitted retroactive deductibility for sums contributed as early as January 1, 1968. Although limited benefit could be derived in 1968 because of the short interval between the passage of the law and the conventions, a total of \$274,500 nevertheless was paid for advertising. By 1972 this figure had jumped to \$2.6 million. H. ALEXANDER, *supra* note 1, at 248-51.

The convention program advertising deduction was repealed in 1974, Upholstery Regulators Act, Pub. L. No. 93-625, § 10(b), 88 Stat. 2108 (1975), by the passage of amendments to the Federal Election Campaign Act of 1971 that provided for complete financing for Presidential nominating conventions. Federal Election Campaign Act Amendments of 1974, Pub. L. No. 93-443, § 406, 88 Stat. 1263 (current version at I.R.C. § 9008).

fifty years with only minor modifications. Although statutory amendments had eliminated two of the more striking abuses, others persisted.³⁵ De facto insulation of campaign finance activities from the taxation process ended, however, during the next seven years. Significantly, this change was unrelated to a searching inquiry into the costs and benefits of taxing political organizations. Rather, a series of public attacks on IRS credibility compelled the Service to abandon its long-standing accommodation with Congress and to commence enforcement of the tax laws with regard to political entities.

1. *Uneven IRS Enforcement: Communist Party v. Commissioner*³⁶

The ongoing conflict between the IRS and the Communist Party during the 1950's and 1960's contrasted sharply with the Service's hands-off policy toward other political parties. Direct IRS action against the party began in 1954, the height of the McCarthy period. In that year, the IRS ordered an audit of the party's books, ostensibly because the organization had not filed income tax or exempt organization returns for 1951.³⁷ Pressed to produce records, including documents that would reveal the sources of its income, the party claimed that it maintained only those records needed for payroll purposes.³⁸ After an unsuccessful attempt to obtain information sufficient to reconstruct the party's taxable income, the Service substituted an alternative figure based on unexplained bank credits and issued a statutory notice of deficiency.³⁹ Because failure to oppose the Service's position could have resulted not only in tax liability

³⁵ Because political organizations remained tax-exempt, the loophole for contributions of appreciated property still was available. Moreover, corporations found other devices to avoid the prohibition against contributions. A corporation could "loan" employees to a candidate while continuing to pay and deduct the employees' salaries. Alternatively, a corporation might hire a campaign worker and pay him a "deductible" salary, but leave the employee's time free for campaign activities. See Weiss, *supra* note 19, at 475-76.

³⁶ 373 F.2d 682 (D.C. Cir. 1967). For earlier incarnations of this case, involving primarily the same set of operative facts, see *Communist Party v. Commissioner*, 332 F.2d 325 (D.C. Cir. 1964); *Communist Party v. Moysey*, 141 F. Supp. 332 (S.D.N.Y. 1956); *Communist Party v. Commissioner*, 24 T.C.M. (CCH) 1468 (1965); *Communist Party v. Commissioner*, 38 T.C. 862 (1962).

³⁷ See *Communist Party v. Commissioner*, 24 T.C.M. (CCH) 1468, 1468 (1965). The Party alleged that its failure to file tax returns was consistent with the standard practices of all other political organizations, practices that the Service had not questioned in the past. See *Communist Party v. Moysey*, 141 F. Supp. 332, 339 (S.D.N.Y. 1956).

³⁸ See *Communist Party v. Commissioner*, 24 T.C.M. (CCH) 1468, 1468 (1965).

³⁹ *Id.* at 1468-69.

for 1951, but also in income taxation in subsequent years—an outcome that would have placed the party at a financial disadvantage relative to other political parties—the Communist Party vigorously contested the asserted deficiency.

In the Tax Court the party advanced arguments that: (1) the Service had determined the deficiency in an arbitrary manner; and (2) as a political organization, the Communist Party was exempt from income taxation.⁴⁰ The Tax Court refused on procedural grounds to consider the second argument⁴¹ and rejected the first argument by holding that the Service's reliance on unexplained bank credits to reconstruct taxable income was permissible.⁴² On appeal, the Court of Appeals for the District of Columbia Circuit overturned the Tax Court's determination. The court found the government's method of arriving at taxable income inadequate and remanded the case to enable "allowable deductions to be ascertained with greater certainty."⁴³ The court also disagreed with the Tax Court's holding that the issue of tax exemption had not been duly raised. The court of appeals ordered reconsideration on remand, noting with a trace of sarcasm:

[T]he Government now assures us that all political parties, including petitioner, are taxable associations under the statute. That may be, but the Tax Court did not so rule; and petitioner is entitled to an adjudication in that court of its contention that the statute is not to be so construed because the Commissioner and his predecessors have never so construed it.⁴⁴

On remand, the government capitulated on virtually all of the

⁴⁰ *Id.* at 1469-70.

⁴¹ The Tax Court essentially maintained that the Party had not duly raised the tax exemption issue. *Id.* at 1470.

⁴² *Id.* at 1469-70.

⁴³ *Communist Party v. Commissioner*, 373 F.2d 682, 684 (D.C. Cir. 1967). The court of appeals emphasized:

The total of these [bank] deposits is not, however, the same as the net income on which the deficiency was found, and the record does not inform us as to how the deficiency was computed. This latter figure comes from the examining agent's report, which characterizes it only as reflecting "all bank credits" for 1951. The agent was unable, without his work papers, to supply further details as a witness at the trial. He said he had turned those papers over to a superior, but, when asked by petitioner to produce them, the Government said that none were in existence.

Id. at 683.

⁴⁴ *Id.* at 684 (footnote omitted). The court recognized the significant stake that other political parties had in the outcome of the case and suggested that these parties might appear before the Tax Court on remand. *Id.* at 684 n.2.

asserted tax liability.⁴⁵ The government's abrupt turnabout may have been attributable to the Service's inability to establish with any measurable certainty the deductions to which the Communist Party was entitled. A more plausible explanation, however, is that the Service realized that on remand the Tax Court would find a history of nonenforcement—as the Communist Party had maintained. Subsequent events support this conclusion. Shortly after the final disposition of *Communist Party*, the IRS issued Revenue Procedure 68-19,⁴⁶ which stated publicly for the first time that recipients of political funds “may” file federal tax returns.⁴⁷ The cryptic, tentative nature of this Revenue Procedure raised serious questions about the Service's actual commitment to enforcement.⁴⁸ Arguably,

⁴⁵ See H.R. REP. No. 1502, 93d Cong., 2d Sess. 104 (1974).

⁴⁶ Rev. Proc. 68-19, 1968-1 C.B. 810.

⁴⁷ After confirming that “[p]olitical funds are not taxable to the political candidate by or for whom they are collected if they are used for expenses of a political campaign or some similar purpose,” *id.*, the revenue procedure warned:

Detailed substantiating records should be kept by the political candidate or other custodian so as to enable the candidate to account accurately for the receipt and disbursement of political funds . . . Disbursements will be included in the income of the political candidate in the absence of a showing that the funds were used for campaign or similar purposes or repaid to known contributors.

Id. at 811. In a further statement that income from unexpended funds “may” be reported on a Fiduciary Income Tax Return, the revenue procedure offered the first suggestion that such income would be subject to income taxation. *Id.*

In contrast, the Service had stated in I.T. 3276, 1939-1 C.B. 108, that political gifts received by individuals and political organizations were not taxable income. At that point the IRS seemed to be concerned primarily with the manner in which property was received, rather than with whether political organizations were tax exempt. Nearly 40 years later the Service directed its field offices not to require political organizations to file income tax returns. See Announcement 73-84, 1973-2 C.B. 461; TAX MNGM'T MEM. (BNA), Apr. 1, 1974, at 3. One commentator has described this as a “somewhat astonishing step”:

No published statement was ever made to the general public concerning this legislatively unsanctioned tax exemption. . . . The surprising aspect of the field office directive was not that it recognized the lack of taxable income by political organizations generally but that it granted a universal, unannounced, and legislatively unsanctioned tax exemption to political organizations instead of merely having a case by case determination of whether any tax was due, as was true for other types of organizations.

Id. at 3.

Curiously, while the field offices were under orders not to require tax returns from political entities, the Service issued several private rulings holding that political organizations should file tax returns and that interest income earned on campaign funds was taxable. Having announced neither position publicly, the IRS could argue both sides of the issue. See Announcement 73-84, *supra*, at 461 (IRS policy statement acknowledging the inconsistency of the two approaches). Despite the Service's dual policies, “apparently no political organization ever felt compelled to file a tax return.” TAX MNGM'T MEM., *supra*, at 3. See also R. BOEHM, POLITICAL EXPENDITURES A-42 (BNA Tax Mngm't Portfolio No. 231, 1978).

⁴⁸ The IRS began to enforce Rev. Proc. 68-19 on a selective basis in 1972. In that year, the

the Revenue Procedure was issued to lend some support—retrospectively—to the IRS stance in *Communist Party* and to offer at least a modicum of administrative authority for future efforts in the continuing struggle with the Communist Party. Ironically, this attempt to tax a fringe political party would have far greater implications in the near future. By announcing publicly that political parties might be taxed, the Service had made a dramatic shift in its stated public policy—if not in its enforcement stance. Once announced, this policy change would be difficult to depart from in the future and ultimately would snare the major political parties.

2. Congressional Manipulation of the Tax Laws

While the IRS was recognizing openly the possibility of taxing political income, a fifteen-year debate over the use of the tax laws to encourage more widespread political contributions was culminating in Congress.⁴⁹ Advocates of electoral reform, backed by an array of respected political scientists and attorneys,⁵⁰ for years had argued that allowing taxpayers credits for contributions to political organizations would induce greater participation in campaign finance, diluting the immense power of a relatively few wealthy campaign financiers.⁵¹ Opponents of the credit proposals contended that the real issue should be the desirability of opening the political process to income taxation, with the attendant potential for taxpayer abuse and IRS scrutiny. Particularly troublesome was what opponents viewed as a constitutionally violative scheme for verifying that a

Service sent a letter to Congressman Frank Evans, citing the revenue procedure as authority for collecting taxes on income earned on surplus campaign committee funds. In a 1973 letter to Senator Gaylord Nelson, the Service stated that the "may" in Rev. Proc. 68-19 really meant "shall." See 23 CATH. U.L. REV. 322, 330-31 (1973).

⁴⁹ Academic and congressional proposals for tax incentives for political contributions were first made in 1955. See Alexander, *Financing the 1960 Election*, in STUDIES IN MONEY IN POLITICS, Study Five at 29 (H. Alexander ed. 1965). For a history of the futile efforts to enact a suitable measure, see Golden, *supra* note 2, at 224 n.26.

⁵⁰ See, e.g., *Hearings on Campaign Contributions, Political Activities, and Lobbying Before the Senate Special Comm. to Investigate Political Activities, Lobbying, and Campaign Contributions*, 84th Cong., 2d Sess., & 85th Cong., 1st Sess. 1257 (1956-1957) (memorandum of Stanley Surrey); H. ALEXANDER, *TAX INCENTIVES FOR POLITICAL CONTRIBUTIONS* 7 (1961); C. BANE, *AMERICAN POLITICS AND THE PARTY SYSTEM* 499 (2d ed. 1955). Several commentators recently have reiterated these views. See H. ALEXANDER, *supra* note 4, at 193-94, 296-97; D. DUNN, *FINANCING PRESIDENTIAL CAMPAIGNS* 148-49 (1972).

⁵¹ See PRESIDENT'S COMMISSION ON CAMPAIGN COSTS, *FINANCING PRESIDENTIAL CAMPAIGNS* 13-16 (1962); Goldman, *Income Tax Incentives for Political Contributors: A Study of the 1963 Proposals*, 11 U.C.L.A. L. REV. 212 (1964); Peters, *Political Campaign Financing: Tax Incentives for Small Contributors*, 18 LA. L. REV. 414 (1958).

contributor in fact had made a contribution of a certain amount to a qualifying political organization.⁵² Fears that IRS involvement in the verification process could lead to identification of the political affiliations of contributing taxpayers and inspection of the records of donee political organizations stalled the legislation for sixteen years. In 1971 Congress finally enacted a bill affording a maximum \$12.50 credit or \$50 deduction to individual taxpayers.⁵³ The latter provision is difficult to reconcile with the legislation's original purpose of diluting the power of wealthy contributors.⁵⁴ During this same time Congress established a check-off system permitting each taxpayer to allocate one dollar of his taxes for use in Presidential campaigns.⁵⁵ The Treasury was to accumulate all money collected

⁵² For discussion of proposals to solve the verification problem, see generally Goldman, *supra* note 51, at 232-36; Peters, *supra* note 51, at 434-35.

⁵³ Revenue Act of 1971, Pub. L. No. 92-178, § 701, 85 Stat. 497 (codified at 26 U.S.C. §§ 41, 642 (1976)). The Revenue Act of 1978 altered the deduction-credit alternative by repealing the deduction and increasing the amount of the credit. See note 3 *supra*.

⁵⁴ On identical contributions the deduction would benefit a taxpayer in the 50% bracket twice as much as a taxpayer in the 25% bracket. A \$50 maximum deduction would be unlikely to attract more major contributors, however, because the tax benefits would be insignificant in comparison with the magnitude of the contributions. In this sense, the legislation can be characterized as progressive. See B. BITTKER & L. STONE, *supra* note 6, at 315. If Congress intended the deduction to encourage more middle income contributors to make moderate contributions, the result seems to have been otherwise. See Adamany, *supra* note 5, at 3 (charging that the deduction-credit has failed to induce broader participation).

⁵⁵ Revenue Act of 1971, Pub. L. No. 92-178, § 801, 85 Stat. 497 (codified at I.R.C. §§ 9001-9013). The Presidential Election Campaign Fund Act of 1966, Pub. L. No. 89-809, tit. III, §§ 302-305, 80 Stat. 1587 (current version at I.R.C. § 6096), also had provided for a one dollar check-off system, but the following year Congress barred distribution of the funds until severe problems with the administration of the check-off system could be resolved. See Act of June 13, 1967, Pub. L. No. 90-26, § 5, 81 Stat. 57; D. ADAMANY, *CAMPAIGN FINANCE IN AMERICA* 259 (1972).

Intensive politicking surrounded the 1971 measure. The Republicans, in particular, saw the provision as a transparent means of redressing the financial imbalance between the two major parties. President Nixon threatened to veto any tax-cut measure to which the campaign funding provisions were attached, unless the Democrats—who controlled Congress—agreed to postpone the effective date of the check-off legislation until after the 1972 elections. The Democrats assented in order to claim credit in the 1972 election for a tax cut. The Republicans planned to continue fighting the check-off in Congress and the courts after the election. See CONGRESSIONAL QUARTERLY INC., *I DOLLAR POLITICS* 57 (1973) [hereinafter cited as *I DOLLAR POLITICS*]. The provision therefore was made effective as of January 1, 1973, making it unavailable until the 1976 Presidential election. S. REP. No. 553, 92d Cong., 1st Sess. 58 (1971).

Initially, the post-election fight was waged in an administrative forum. The IRS published a separate check-off tax form for 1973, which resulted in minimal taxpayer participation. Only after a considerable outcry from Congress and public interest groups did the Service

in a special fund, allocating it among major and minor political parties according to a predetermined statutory formula.⁵⁶

The changes taking place in political campaigning provide the best explanation for the flurry of congressional activity that resulted in the check-off and deduction-credit statutes. Because electronic media had become the dominant campaign tool, staging a successful campaign now required vast sums of money. Traditionally, candidates had emphasized organization and loyal party workers. If elected, a candidate typically paid off his campaign debts through patronage. Financing, although important in the past, was now crucial to a campaign that required television and radio time, sophisticated advertising spots, scientific polling, and professional campaign organizers. This new style of campaigning mandated a dramatic increase in campaign funding.⁵⁷

Congressional activity in 1971 was not ascribable exclusively, however, to the revolution in political campaign techniques and the

agree to place the check-off option directly on Form 1040. See *I DOLLAR POLITICS*, *supra*, at 57. The entire statutory scheme was questioned in *Buckley v. Valeo*, 424 U.S. 1, 85-109 (1976). The Supreme Court upheld the statute, rejecting first and fifth amendment challenges.

⁵⁶ The money must be distributed according to an established list of priorities. First, a portion of the fund must be allocated to pay for Presidential nominating conventions. I.R.C. § 9008(a). See note 34 *supra*. Funds are allocated next to candidates of qualifying parties according to a statutory formula. I.R.C. § 9004. Any remaining money may be allocated to candidates seeking party nominations. I.R.C. §§ 9031-9042.

⁵⁷ See *Hearings on H.R. 8627, H.R. 8678 and Related Bills Before the Subcomm. on Power and Communication of the House Comm. on Interstate and Foreign Commerce*, 92d Cong., 1st Sess. 65 (1971) (statement of Congressman John Murphy). In 1968 the Nixon campaign ranked as the 79th largest television advertiser, between Schlitz Brewing and Monsanto. The Humphrey campaign's expenditures placed it at 109th, between Sperry Rand and Standard Oil of New Jersey. *Id.*

The cost of campaigning for all offices rose from \$200 million in 1964 to \$300 million four years later, with the expanded use of modern advertising technology accounting for a vast portion of the increase. See Rosenbloom, *Background Paper*, in TWENTIETH CENTURY FUND TASK FORCE ON FINANCING CONGRESSIONAL CAMPAIGNS, ELECTING CONGRESS (1970); Comment, *The Federal Election Campaign Act of 1971: Reform of the Political Process?*, 60 GEO. L.J. 1309, 1309 & n.2, 1315 n.32 (1972). See generally TWENTIETH CENTURY FUND, VOTERS TIME (1969). In 1971 Congress attempted to control media expenditures by passing the Campaign Communications Reform Act, Pub. L. No. 92-225, tit. I, § 104, 86 Stat. 3 (1972) (codified at 47 U.S.C. § 315 (1976)). The ceiling, however, was not particularly low and easily could be circumvented. See Comment, *supra*, at 1315-16, 1319.

By 1972 total expenditures for all campaigns had climbed to \$425 million, H. ALEXANDER, *supra* note 1, at 77, and estimates for 1976 calculated total spending at well over \$500 million—increases greatly exceeding the inflation rate. See *I DOLLAR POLITICS*, *supra* note 55, at 2-5, 11-14; D. ADAMANY, *supra* note 55, at 58-63. While the media continues to be a vital and costly aspect of political campaigning, doubts exist regarding its effectiveness and the extent to which it will be relied upon in the future. See, e.g., D. ADAMANY & G. AGREE, *supra* note 1, at 76; *I DOLLAR POLITICS*, *supra* note 55, at 12-13.

concomitant need for greater campaign finance. The Democratic Party's acute need for financing was an important additional consideration. Although the Democratic Party controlled Congress, it faced a well-heeled Republican Party and an incumbent President.⁵⁸ Manipulation of the tax laws could redress the long-term financial imbalance between the parties. At a time when a candidate's chances of winning an election seemed to be directly proportional to the amount of money spent on his campaign, a powerful incentive existed to put aside hypothetical concerns over the potential for IRS involvement in the political process.

The new legislation, following so closely the Service's own tentative steps away from a policy of de facto tax exemption, represented more than an attempt to augment campaign contributions by increasing participation. Both the deduction-credit and the check-off measures revealed Congress's self-serving willingness to tolerate some role, albeit a vague one, for taxation in the political realm.

3. Active IRS Enforcement Commences

In Revenue Procedure 68-19 the IRS had recognized formally for the first time the possibility of taxing the income of political organizations. At least a decade earlier, however, the Service had established a firm enforcement posture regarding the gift tax liability of contributors.⁵⁹ The gift tax represented a less sensitive issue because, unlike administration of the income tax law, enforcement of the gift tax entailed IRS involvement only with contributors and not with the donee organizations. Moreover, in light of the annual exclusion of \$3,000 per donee,⁶⁰ and the \$30,000 lifetime exemption per donor,⁶¹ the tax placed a relatively insignificant burden on most contributors.

Not long after Congress enacted the deduction-credit and check-off legislation, the Court of Appeals for the Fifth Circuit considered

⁵⁸ Although attempts to activate the check-off system for the 1972 elections faltered, the measure promised to palliate the Democratic Party's chronic financial difficulties in future Presidential campaigns. The party's financial straits had been painfully obvious in the previous Presidential election when in October of 1968, with less than one month before the election, Humphrey's campaign essentially had exhausted its funds. See Alexander & Meyers, *A Financial Landslide for the G.O.P.*, *FORTUNE*, Mar. 1970, at 104, 187.

⁵⁹ *But see* note 12 *supra*.

⁶⁰ I.R.C. § 2503(b).

⁶¹ Int. Rev. Code of 1954, ch. 736, § 2521, 68A Stat. 410 (repealed 1976) (effective for gifts made prior to Jan. 1, 1977). For post-1976 gifts, a credit is available that will reach \$47,000 by 1981. I.R.C. § 2505(a)-(b).

a case⁶² directly challenging the Service's authority to collect gift tax on political contributions.⁶³ In *Stern v. United States*⁶⁴ the plaintiff and several other taxpayers had contributed substantial sums of money to a committee that they had formed to disburse funds to reform candidates in Louisiana. Mrs. Stern stated that she had made the contributions to promote the election of candidates who would protect her investments by altering Louisiana's economic and tax structures.⁶⁵ The IRS, following its long-standing policy concerning the gift tax liability of contributors, sought to collect the tax. Mrs. Stern argued that no gift tax was due because she had made her contribution in the ordinary course of business to protect her investments. Affirming the decision of the district court, the court of appeals held for Mrs. Stern and emphasized that:

In a very real sense, then, Mrs. Stern was making an economic investment that she believed would have a direct and favorable effect upon her property holdings and business interests in New Orleans and Louisiana. These factors, in conjunction with the undisputed findings of the lower court that the expenditures were bona fide, at arms length and free from donative intent, lead us, in light of what we have said above, to the conclusion that the expenditures satisfy the spirit of the Regulations and are to be considered as made for an adequate and full consideration.⁶⁶

The potential impact of the *Stern* decision on campaign finance cannot be overestimated. The *Stern* rationale, coupled with the de facto income tax exemption of political organizations, presented the possibility of insulating the entire political process from all forms of taxation. When a contributor transferred property to a political organization, and that entity earned income on the contribution, neither would be required to pay any gift or income taxes, or to comply with any reporting requirements. Although the contributor

⁶² *Stern v. United States*, 436 F.2d 1327 (5th Cir. 1971).

⁶³ One other court had addressed the issue of gift taxation of political contributions, but in a different factual context. In *Du Pont v. United States*, 97 F. Supp. 944 (D. Del. 1951), the court held that Lammot Du Pont's \$6,000 contribution to the National Economic Council, an organization advocating free enterprise, was subject to gift taxation. Du Pont argued that he had made a payment to the Council for services that it would perform by fostering a national economic climate favorable to his investments. The court rejected this contention, stressing that the payments were not ordinary and necessary business expenses and that no identifiable consideration had been received. In this sense, the court likened Du Pont to a contributor who gives money to a political party sharing his economic viewpoint. *Id.* at 947.

⁶⁴ 436 F.2d 1327 (5th Cir. 1971).

⁶⁵ *Id.* at 1328-29.

⁶⁶ *Id.* at 1330 (footnote omitted).

would have to establish a bona fide business purpose for the transfer, this would not present serious difficulties in many cases.⁶⁷ Not surprisingly, the IRS strongly opposed the *Stern* decision and refused to follow it in any other circuit.⁶⁸

As the 1972 Presidential campaign accelerated, IRS opposition to the *Stern* decision⁶⁹ meant that several major contributors, including Chicago insurance multimillionaire W. Clement Stone,⁷⁰ faced the prospect of substantial gift tax liability. These contributors circumvented the gift tax by using a rather crude technique: the establishment of thousands of paper political committees. A sole contributor would make a contribution not exceeding \$3,000 to each of the paper committees. Each distinct contributor fell within the gift tax exclusion for transfers to any one donee in a calendar year.⁷¹

⁶⁷ The court's reliance on bona fide business purpose, although rooted in the Internal Revenue Code, rested primarily on the regulations. I.R.C. § 2501 (a)(1) imposes the gift tax on "the transfer of property by gift." The Code, however, does not define "gift," leaving this process to the Service and the courts. I.R.C. § 2512(b) does provide that "[w]here property is transferred for less than an adequate and full consideration in money or money's worth, then the [difference] shall be deemed a gift . . ." Treas. Reg. § 25.2512-8 (1958) amplifies this definition, stating that "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth." Mrs. Stern's contribution does not appear to be a transaction "made in the ordinary course of business" under the usual meaning of these terms. The Supreme Court, however, has opposed such a restrictive reading in special circumstances. See, e.g., *Harris v. Commissioner*, 340 U.S. 106 (1950) (marital transfer pursuant to property settlement, although not fitting conventional notions of being "in the ordinary course of business," qualifies for exemption from gift tax).

⁶⁸ Rev. Rul. 72-583, 1972-2 C.B. 534. Moreover, the Service stated that even in the Fifth Circuit the decision would be followed only in cases "on all-fours" with *Stern Id.* Accordingly, commentators urged contributors to pursue other means of reducing their gift tax liability. See, e.g., Cohen, *Recent case indicates some political gifts may not be subject to the gift tax*, 36 J. TAX. 146, 147 (1972). In June of 1973 legislation to remove political contributions from the definition of "gift" for gift tax purposes was introduced in Congress, but died in the Senate Finance Committee. S.2065, 93d Cong., 1st Sess. (1973) (gifts made to political committees will be deemed gifts to the candidate, with a limited exception).

⁶⁹ At least one commentator has suggested that the Service's opposition to *Stern* stimulated contributor interest in finding techniques to avoid gift tax. See 23 CATH. U.L. REV. 322, 325 (1973). See generally 46 TUL. L. REV. 344 (1971); 40 U. CIN. L. REV. 381 (1971).

⁷⁰ For an account of Stone's and other significant contributors' efforts to avoid paying gift tax on political contributions, see note 71 *infra*. Mrs. John D. Rockefeller, Jr., in contrast, contributed \$1,482,625 through a single committee to Nelson Rockefeller's campaign in 1968, resulting in a gift tax liability of \$854,483. H. ALEXANDER, *supra* note 1, at 359.

⁷¹ Stone contributed over \$2 million, writing 700 checks for \$3,000 each to separate Nixon campaign finance committees. See Rogovin, *supra* note 8, at 18. Mellon heir Richard Scaife acknowledged that he had contributed \$990,000 by making payments of \$3,000 to each of 330 separate committees. Wash. Post, Oct. 25, 1972, § A, at 1, col. 5. One estimate calculated

Although this practice was widely regarded as a transparent device for avoiding taxes, contributors sought an IRS ruling approving the technique. To the astonishment of many, the IRS responded with Revenue Ruling 72-355, which held that each recipient committee was a separate donee for tax purposes, even though all were mere conduits to the Republican National Committee and all were controlled by interlocking directorates.⁷²

The ruling produced a result totally at odds with the Service's defense of the gift tax following the *Stern* decision, intimating that external pressures had influenced the IRS decision. Tax Analysts and Advocates, one of many public interest groups to criticize the ruling, brought suit to enjoin the IRS from adhering to the decision.⁷³ In a second action, Ralph Nader sought to compel a

Scaife's gift tax savings at between \$244,000 and \$590,000. Mintz, *Politics, Gifts, and Taxes*, Wash. Post, Dec. 25, 1972, § C, at 1, col. 7, 10, col. 1. Democrats as well as Republicans evaded the gift tax: McGovern campaign workers admitted establishing several hundred committees exclusively to receive contributions in \$3,000 installments. Landauer, *How Political Donors Avoid Gift, Gains Taxes by Contributing Stock*, Wall St. J., Sept. 27, 1972, at 1, col. 6.

Paper committees were used effectively for gifts of appreciated property as well as for cash contributions. Republican financiers sent out form letters reading in part:

I am delivering this stock to you as my agent to effect transfer thereof as herein set forth . . . You are authorized and directed to divide this stock into certificates with values of not [sic] to exceed \$3,000 each, on the date of transfer, and to cause one of the certificates, as my agent for such purpose, to be transferred to each of the following separate entities.

Spaces for listing the paper committees appeared below this statement, and each contributor received a list of 50 committees from which to choose his donees. Landauer, *supra*, at 24, col. 4.

⁷² Rev. Rul. 72-355, 1972-2 C.B. 532. The ruling stated further that:

Where, however, political organizations have essentially the same officers and supported candidates and no substantial independent purpose, the organizations will be treated as one and gifts to them by an individual will be aggregated for purposes of section 2503(b) of the Code. For purposes of this paragraph, the officers or supported candidates will not be deemed to be essentially the same if at least one-third of the officers or candidates are different in each of the committees.

Id. The requirement that one-third of the membership vary from committee to committee was easily satisfied; the ruling elevated form over substance. See Feinschreiber & Granwell, *Avoiding the Gift Tax on Political Contributions: Obstacles and Opportunities*, 50 TAXES 671, 682 (1972) (six officers and six candidates could be arranged to form 2,209 separate committees to which \$6,627,000 per year could be contributed without any gift tax liability).

⁷³ *Tax Analysts & Advocates v. Shultz*, 376 F. Supp. 889 (D.D.C. 1974). The district court ruled against the government, resting the decision on *Helvering v. Hutchings*, 312 U.S. 393 (1941), in which the Supreme Court had held that the beneficiaries of a trust, not the trust itself, were donees for purposes of the annual exclusion. To avoid extended litigation, the Service conceded that Rev. Rul. 72-355 was no longer good authority. T.I.R. 1325, Dec. 29, 1974. On appeal, the *Tax Analysts & Advocates* decision ultimately was vacated and

recalcitrant IRS to disclose, pursuant to the Freedom of Information Act, alleged communications between IRS officials and the White House concerning the Service's policy on multiple gift committees.⁷⁴ Subsequent disclosures confirmed that the executive branch had pressured the IRS and that the office of the Chief Counsel of the Treasury—in a departure from normal procedure—had drafted the ruling.⁷⁵

These revelations raised serious questions regarding the integrity of the IRS and thus threatened the effective functioning of the tax system. Within weeks, the IRS publicly sought to recoup its prestige by shifting to Congress the burden of immediately enacting a comprehensive scheme for taxation of campaign finance. In April of 1973, the Secretary of the Treasury, testifying before the House Committee on Ways and Means, pleaded for a legislative solution that would "minimize the involvement of the Internal Revenue Service in the affairs of the political system."⁷⁶

At the height of Watergate and in anticipation of the 1974 elections, the IRS not only challenged Congress to act, but also took steps of its own to rehabilitate its tarnished enforcement image. In late 1973 and early 1974, the Service issued a series of rulings setting forth the following principles: (1) all political organizations would be required to file tax returns;⁷⁷ (2) political organizations would be regarded as taxable associations,⁷⁸ and campaign funds administered by or for candidates would be treated as trusts taxable on all investment income;⁷⁹ (3) gifts of appreciated property would be

remanded for dismissal of the complaint as moot. *Tax Analysts & Advocates v. Simon*, 75-1 USTC ¶ 13,052 (D.C. Cir. Feb. 18, 1975). The court of appeals ordered the remand because in the interim Congress had passed a law exempting political contributions from federal gift taxation. See notes 105-11 *infra* and accompanying text.

⁷⁴ *Nader v. I.R.S.*, Civil No. 1851-72 (D.D.C., filed May 18, 1973). After nearly a year of legal maneuvering, the Service finally released IRS and Treasury records. See 23 CATH. U.L. REV. 322, 326 n.26 (1973).

⁷⁵ See H. ALEXANDER, *supra* note 1, at 360. Commenting on the procedures employed, Congressman Henry Reuss suggested an "'apparent combination in restraint of tax collection.'" See 23 CATH. U.L. REV. 322, 326 n.26, 327 n.27 (1973) (quoting Press Release issued by Congressman Reuss, June 9, 1973, at 3).

⁷⁶ *Public Hearings Before the House Comm. on Ways and Means on General Tax Reform* (pt. 18), 93d Cong., 1st Sess. 6873, 6889-89 (1973) (statement of Secretary of the Treasury George P. Shultz).

⁷⁷ Rev. Rul. 74-21, 1974-1 C.B. 14, 16.

⁷⁸ *Id.*

⁷⁹ Rev. Rul. 74-23, 1974-1 C.B. 17, 18. In Rev. Rul. 74-21, 1974-1 C.B. 14, 15, the Service had concluded that a particular campaign group most closely resembled a corporation, because the organization had associates, carried on activities furthering the goals for which it

taxable to the donee organization;⁸⁰ and (4) contributions that congressmen receive for newsletter funds would be includable in their gross income.⁸¹ These policies, if literally enforced, posed a major threat to the system of de facto tax exemption of political organizations that had persisted largely intact for sixty years.

II. THE STATUTORY SYSTEM OF TAX EXEMPTION

Congress reacted quickly to the prospect of campaign finance taxation, passing without public comment or congressional debate legislation that addressed each of the positions endorsed by the Service in its rulings. Despite the Senate Finance Committee's recognition that this legislation involved questions concerning the "delicate balance between the need to protect the revenue and of [*sic*] the need to encourage political activities which are the heart of the democratic process,"⁸² the legislation went no further in resolving the question of taxation's proper role in the political process.

A. *The Legislative History of the New Law*

Congress's initial attempt to enact a statutory tax exemption for the political process lay buried in the Energy Tax and Individual Relief Act of 1974,⁸³ which was reported by the House Committee on Ways and Means on November 26, 1974.⁸⁴ Because of maneuvering on unrelated provisions, the legislation did not reach the House floor.⁸⁵ The Senate Finance Committee, however, soon included

had been created, granted its officers continuous exclusive authority to make management decisions, and possessed an identity unaffected by changes in personnel. In contrast, Rev. Rul. 74-23 required the individual candidate to file a Fiduciary Income Tax Return because his campaign funds remained under his control and not within the power of a separate organization.

⁸⁰ Rev. Rul. 74-23, 1974-1 C.B. 17, 18; Rev. Rul. 74-21, 1974-1 C.B. 14, 16. The Service founded its position on the notion that the transfer of appreciated property does not trigger realization of income. Gain would be realized only when the donee disposed of the property in a taxable sale or exchange. The donee, like any donee of gift property, would take the contributor's basis. I.R.C. § 1015.

⁸¹ Rev. Rul. 73-356, 1973-2 C.B. 31, 32. The Service thus differentiated between newsletter funds and direct contributions, which were characterized as gifts.

⁸² S. REP. No. 1357, 93d Cong., 2d Sess. 26, reprinted in [1974] U.S. CODE CONG. & AD. NEWS 7478, 7502.

⁸³ H.R. 17488, 93d Cong., 2d Sess. (1974).

⁸⁴ H.R. REP. No. 1502, *supra* note 45.

⁸⁵ Senator Russell Long, chairman of the Senate Finance Committee, explained that the bill died in the House before hearings were held because a number of Congressmen felt that the bill taxed the oil industry too lightly. 120 CONG. REC. 40348 (1974). The *Wall Street Journal* offered a different explanation: Congressmen from oil-producing states had voted the

essentially the same provisions in the Upholstery Regulators Act of 1974,⁸⁸ which otherwise concerned the suspension of customs duties on upholstery needles. This "Christmas Tree" bill⁸⁷ was reported out of committee on December 16 without hearings.⁸⁸ The bill was reported favorably by House and Senate Conferences on December 19⁸⁹ and was passed in both Houses on December 20, with virtually no floor debate.⁹⁰ Several Congressmen objected vehemently because copies of the final bill apparently were not made available to them before the vote.⁹¹ Despite these objections and the bill's rather obscure legislative history, President Ford signed the provisions into law on January 3, 1975.⁹²

B. *The Five Critical Elements of the New Law*

The enactment of the campaign finance provisions of the Upholstery Regulators Act represented a legislative counterattack against threatened IRS enforcement of the tax laws in the political arena. The report of the Senate Finance Committee recognized that the Act would "[modify] the tax treatment of political organizations in five major respects":⁹³ (1) exempting political parties from taxation, (2) eliminating gift tax liability, (3) increasing the credit and deduction for contributors, (4) exempting newsletter funds, and

bill down, presumably because it would have increased oil producers' taxes substantially. Wall St. J., Dec. 13, 1974, at 8, col. 2.

⁸⁸ Upholstery Regulators Act, Pub. L. No. 93-625, 88 Stat. 2108 (1975) (current versions at scattered sections of I.R.C.). With the exception of a few differences in phrasing, these provisions were identical to those originally proposed in the House. Compare H.R. 17488, 93d Cong., 2d Sess. §§ 271-274 (1974), as reported by the House Committee on Ways and Means in H.R. REP. No. 1502, *supra* note 45, at 103-13, with Upholstery Regulators Act, Pub. L. No. 93-625, §§ 10-14, 88 Stat. 2108 (1975) (current versions at scattered sections of I.R.C.).

⁸⁷ Congressman William Steiger, in particular, pressed Chairman Ullman as to whether the "pins and needles" bill had in fact become a "Christmas Tree" bill. 120 CONG. REC. 41815 (1974). The bill also included provisions dealing with accrued vacation pay, real estate investment trusts, and interest charges on late tax payments. Upholstery Regulators Act, Pub. L. No. 93-625, §§ 4, 6-7, 88 Stat. 2108 (1974) (current versions at scattered sections of I.R.C.). In retrospect, Steiger's concern seems well-founded, considering the significant tax legislation that Congress enacted after only the most cursory study.

⁸⁹ H.R. 421, 93d Cong., 2d Sess. §§ 10-14 (1974), as reported by the Senate Finance Committee in S. REP. No. 1357, *supra* note 82, at 25-36.

⁹⁰ H.R. REP. No. 1642, 93d Cong., 2d Sess. (1974).

⁹¹ 120 CONG. REC. 41659, 41822 (1974). See generally Golden, *supra* note 2, at 224-25.

⁹² 120 CONG. REC. 41821 (1974).

⁹³ Upholstery Regulators Act, Pub. L. No. 93-625, §§ 10-14, 88 Stat. 2108 (1975) (current versions at scattered sections of I.R.C.).

⁹⁴ S. REP. No. 1357, *supra* note 82, at 4, reprinted in [1974] U.S. CODE CONG. & AD. NEWS 7478, 7481.

(5) taxing contributions of appreciated property.

In the Upholstery Regulators Act, Congress finally and formally exempted from income taxation the contributions received by political organizations.⁹⁴ Congress did provide, however, that political organizations would be subject to tax on investment income, as if they were corporations.⁹⁵ Previously, the Service, in laying out its new policy in the early 1974 rulings,⁹⁶ had indicated that although political organizations would be taxed on investment income, they would not be taxed on campaign contributions.⁹⁷ Although similar to the stance ultimately adopted by Congress, the Service's position had some troublesome aspects. First, in ruling on the exemption of contributions, the IRS emphasized that political organizations generally are *not* exempt from taxation.⁹⁸ In the Upholstery Regulators

⁹⁴ I.R.C. § 527(a).

⁹⁵ I.R.C. § 527(b) provides for the income taxation of "political organization taxable income." Political organization taxable income is defined as the gross income of the organization (excluding "exempt function income") less related deductions. *Id.* § 527(c)(1). Exempt function income is any amount received as:

- (A) a contribution of money or other property,
 - (B) membership dues, a membership fee or assessment from a member of the political organization, or
 - (C) proceeds from a political fundraising or entertainment event, or proceeds from the sale of political campaign materials, which are not received in the ordinary course of any trade or business,
- to the extent such amount is segregated for use only for the exempt function of the political organization.

Id. § 527(c)(3).

I.R.C. § 527(e)(2) defines "exempt function" as:

the function of influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any Federal, State, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, whether or not such individual or electors are selected, nominated, elected, or appointed.

The statute seems to contemplate a two-part test: to qualify for tax exemption, funds must fall within certain categories of receipts and be expended for political purposes. Thus, both investment income and interest income would fail the initial test and would be taxed even if expended for political purposes. The tax would be imposed at corporate rates, but without the benefit of the surtax exemption. *Id.* § 527(b)(1). Curiously, the statute proposes a harsher rule than the IRS had adopted in Rev. Proc. 68-19, 1968-1 C.B. 810. In that ruling the Service indicated that interest earned on *unexpended* campaign funds would be taxable, implying that interest on previously accrued income spent on the campaign would not be taxed.

⁹⁶ See notes 77-81 and accompanying text.

⁹⁷ Rev. Rul. 74-21, 1974-1 C.B. 14, 16. The IRS offered no rationale for this determination. Presumably, the Service found that contributions are made out of "detached and disinterested generosity," although this scarcely could be the case in every instance. See note 7 *supra*.

⁹⁸ Rev. Rul. 74-21, 1974-1 C.B. 14, 15:

An organization that is organized and operated exclusively to engage in activities the

Act Congress rejected this IRS position and established that "a political organization shall be considered an organization exempt from income taxes."⁹⁹ By enacting a statutory tax exemption for political organizations, Congress finally had reversed the Service and, at least superficially,¹⁰⁰ closed an avenue for IRS involvement in campaign finance.

Second, the Service's ruling exempted campaign contributions from taxation on the ground that the contributions constituted gifts. The IRS, however, carefully ignored other sources of funding, leaving open the possibility of taxing other types of receipts. The legislation expressly brought not only contributions, but also proceeds from political fundraising and entertainment events, receipts from sales of political campaign materials, and membership dues, fees, and assessments within the exemption.¹⁰¹ In light of the increasingly critical role these other items play in campaign finance, the differences in the scope of the congressional and IRS tax exemptions is significant. Congress took a further step by defining the term "contributions" to include "a gift, subscription, loan, advance, or deposit, of money, or anything of value, [as well as] a contract, promise, or agreement to make a contribution, whether or not legally enforceable."¹⁰² This definition far exceeded the ordinary connotation of the term and set forth a broader meaning than the IRS was likely to adopt on its own.

Finally, the legislation extended the treatment accorded political organizations to the segregated campaign funds of individual candidates.¹⁰³ This provision eliminated the differential treatment, attendant confusion, and potential rateshopping introduced by the Service's attempt to tax political organizations as corporations while taxing candidates' campaign funds as trusts.¹⁰⁴

purpose of which is to influence the nomination or election of individuals to public office is not one of the organizations that may be exempt from the Federal income tax for purposes described in section 501. Nor is such an organization one covered by any other provision of the Code as exempt from the Federal income tax. There is no judicial decision holding that such an organization is exempt from such tax.

⁹⁹ I.R.C. § 527(a).

¹⁰⁰ IRS activity was only superficially precluded because the institution of a statutory scheme of exemption presages IRS involvement in enforcement, especially when the statute is drafted so ambiguously. See notes 130-52 and accompanying text.

¹⁰¹ I.R.C. § 527(c)(3). See note 95 *supra*.

¹⁰² I.R.C. § 271(b)(2) (incorporated in § 527(e)(3)).

¹⁰³ See *id.* § 527(e)(1), (f)(3).

¹⁰⁴ See notes 9, 78 & 79 *supra* and accompanying text.

In addition to granting income tax exemption to political organizations, Congress exempted contributors from gift tax liability. Following *Stern*, the IRS steadfastly had adhered to the position that all political contributions were subject to gift taxation.¹⁰⁵ Congress expressly rejected this rationale, emphasizing that "it is inappropriate to apply the gift tax to political contributions because the tax system should not be used to reduce or restrict political contributions."¹⁰⁶

In the gift tax provision, Congress specifically exempted—without exceptions or qualifications—the transfer of property to a political organization.¹⁰⁷ The law thus went considerably beyond the *Stern* rationale, which was limited to contributions for which there was a demonstrable, bona fide business purpose.¹⁰⁸ Moreover, the new law effectively resolved the issue raised in the *Tax Analysts & Advocates*¹⁰⁹ case: with the enactment of the blanket gift tax exemption,

¹⁰⁵ See notes 59-68 *supra* and accompanying text. Despite the established position of the Service, one commentator has stated that "[p]olitical contributions have played a somewhat shadowy role on the gift tax scene. The popular conception seems to be that they are not really gifts subject to tax and it has been widely speculated that substantial contributions are never reported for gift tax purposes." Faber, *Gift Tax Planning: The New Valuation Tables; Net Gifts; Political Gifts; and other Problems*, in NEW YORK UNIVERSITY THIRTY-FIRST INSTITUTE ON FEDERAL TAXATION 1217, 1244 (1973). Another commentator has speculated that compliance probably was "negligible" even before *Stern*. Kaplan, *supra* note 2, at 347. To the extent that these assessments are accurate, taxpayer behavior regarding the gift tax essentially paralleled political organizations' conduct regarding the income tax. See note 47 *supra*.

¹⁰⁶ H.R. REP. NO. 1502, *supra* note 45, at 110. Congress articulated no further explanation. On the floor of the House, Chairman Ullman remarked that "campaign contributions in reality are not a gift but rather constitute contributions to further the general political or good government objectives of the donor." 120 CONG. REC. 41818 (1974). Several commentators have offered a different justification for a gift tax exemption. The primary purposes of the gift tax are to complement the estate tax, to prevent avoidance of estate tax by lifetime gifts, and to deter income-splitting among family members. See Faber, *supra* note 105, at 1263-64; Lehrfeld, *The Gift Tax Implications of Political Contributions*, 54 A.B.A.J. 1032 (1968); Streng, *supra* note 2, at 174. *But see* Schoenblum, *supra* note 12, at 653-55.

¹⁰⁷ I.R.C. § 2501(a)(5) provides that the tax otherwise imposed by I.R.C. § 2501 (a)(1) on the transfer of property by gift "shall not apply to the transfer of money or other property to a political organization (within the meaning of section 527(e)(1)) for the use of such organization." The implication is, however, that political contributions are gifts. The provision is effective with regard to transfers made after May 7, 1974, but it fails to specify the proper tax treatment of contributions made prior to that date. The Tax Court's recent decision in *Carson v. Commissioner*, 71 T.C. 252 (1978), indicates that these previous contributions will not be classified as gifts for gift tax purposes. Moreover, to the extent that *Carson* is applied to transfers made after May 7, 1974, it could undermine the statutory scheme. Because *Carson* was not a majority decision, however, the case's precedential value remains uncertain.

¹⁰⁸ Several commentators have viewed the *Stern* case as factually unique and of little precedential value for the vast majority of political contribution cases. See Faber, *supra* note 105, at 1245-58; Streng, *supra* note 2, at 173. *But see* note 67 *supra* and accompanying text.

¹⁰⁹ *Tax Analysts & Advocates v. Shultz*, 376 F. Supp. 889 (D.D.C. 1974).

a multitude of paper committees was no longer needed to maximize the number of \$3,000 inclusions.¹¹⁰

The principal beneficiaries of the gift tax provision, other than the donee organizations, were contributors who were in a position to make contributions exceeding \$3,000 per organization or candidate—scarcely the individuals Congress ostensibly sought to bring into the political system through tax incentives. Moreover, the legislation appeared to be inconsistent with Congress's purported effort to dilute the power of the small group of wealthy contributors. Behind a smokescreen of populist rhetoric, Congress was reshaping the tax system to attract even greater funding from those with the most money to contribute.¹¹¹

The Upholstery Regulators Act doubled the maximum income tax credit and deduction for political contributions,¹¹² exemplifying

¹¹⁰ The enactment of this legislation effectively mooted the *Tax Analysts & Advocates* case. See note 73 *supra*. The district court opinion, in fact, may have been one of the major incentives for the legislation. Enjoining the Service from enforcing its multiple committees ruling, the district court stated that "political contributions are subject to the gift tax." *Tax Analysts & Advocates v. Shultz*, 376 F. Supp. 889, 899 (D.D.C. 1974) (emphasis in original). The court also appeared to endorse the Service's attempt to limit the application of *Stern*. See *id.* at 899 n.33.

¹¹¹ Curiously, Congress passed the Federal Election Campaign Act Amendments of 1974, Pub. L. No. 93-443, § 101(a), 88 Stat. 1263 (amending 18 U.S.C. § 608(b)(1)-(3)), just two months prior to the Upholstery Regulators Act. These amendments limited contributions to an individual candidate's committee to \$1,000 per primary, run-off, and general election, and set a \$5,000 ceiling on contributions by an independent political committee. Furthermore, these amendments set \$25,000 as the maximum amount that an individual could contribute in any election year. *Id.*

At first glance, these contribution limitations appear to defeat the purpose of the gift tax exemption. For several reasons, however, the gift tax exemption was not meaningless. First, substantial doubts existed regarding the constitutionality of the contribution limits. The Supreme Court did hold a number of the contribution restrictions unconstitutional in *Buckley v. Valeo*, 424 U.S. 1 (1976), but upheld the general framework. Second, contributors had no reason to assume that contribution limits would be enforced more seriously than they had been in the past, especially when congressional leaders were to choose the members of the enforcing agency, the Federal Election Commission. The Supreme Court later declared the Federal Election Commission unconstitutional as composed, *id.* at 140, and the Commission has since been restructured. Third, the limits on campaign contributions were indexed for inflation, ensuring that the ceilings would rise in inflationary periods. Given an inflationary trend, the gift tax exemption would gain significance over time. Fourth, contributors were permitted to give more than \$3,000 to multicandidate and party committees, contributions for which the annual \$3,000 exclusion would be inadequate. Finally, these federal contribution limits did not govern contributions to state and local candidates and their committees.

¹¹² Upholstery Regulators Act, Pub. L. No. 93-625, § 12 (a)-(b), 88 Stat. 2108 (1975) (codified at I.R.C. §§ 41(b)(1), 218(b)(1)). The credit ceiling was raised from \$12.50 to \$25.00 (\$50.00 in the case of a joint return). I.R.C. § 41(a)-(b). The provision that a credit could be claimed for no more than one-half of the taxpayer's total contributions, regardless of the type

Congress's preoccupation with stimulating campaign finance, even at the price of sacrificing broader participation. Previously, a contributor could claim a credit or deduction only for contributions made in the year that the candidate formally announced his intention to run for office.¹¹³ The new law permitted the contributor to take the credit or deduction for contributions to an undeclared candidate, provided the donee announced his candidacy by the subsequent year.¹¹⁴ By increasing the number of years in which credits and deductions would be available, Congress encouraged an increase in total contributions. More important, Congress gave its members and other incumbents a financial advantage: an incumbent is well-known prior to a formal announcement of his candidacy and is likely to have an organization to solicit, receive, and manage funds before an opponent has even come forward.¹¹⁵

The provisions that Congress enacted governing newsletter funds also reflect reliance on the tax system both to encourage campaign finance and to strengthen the relative positions of incumbents. Elected officials traditionally had published newsletters to inform constituents about their positions on a variety of issues. Newsletters long had been recognized, however, as playing more than an informational role. Professional politicians regarded the newsletter as an effective political tool for maintaining visibility with the electorate and projecting a positive public image.¹¹⁶

of return, was retained. *Id.* § 41(a). The maximum amount deductible was increased from \$50 to \$100 (\$200 in the case of a joint return). Upholstery Regulators Act, Pub. L. No. 93-625, §§ 11(d), 12(b), 88 Stat. 2108 (1975) (repealed 1978).

¹¹³ Revenue Act of 1971, Pub. L. No. 92-178, § 701(a), 85 Stat. 497 (amended by Upholstery Regulators Act, Pub. L. No. 93-625, § 11(e), 88 Stat. 2108 (1975)) (current version at I.R.C. § 41 (c)(2)(A)).

¹¹⁴ More precisely, the statute authorizes a credit for political contributions to a candidate, defining "candidate" to include one who "publicly announces before the close of the calendar year following the calendar year in which the contribution or gift is made that he is a candidate." I.R.C. § 41(c)(2)(A).

¹¹⁵ As one commentator has pointed out, a bias in favor of the major national political parties also exists in the current statutory provisions. *See* Golden, *supra* note 2, at 230-32. Contributions may be made even in nonelection years to the national committees of parties that placed candidates or electors for President and Vice President on the official election ballot of at least ten states in the previous election. I.R.C. § 41(c)(1)(C), (c)(3).

¹¹⁶ Congressman John Anderson, chairman of the House Republican Conference, has described the newsletter, for which Congress currently has allocated funds to its members, as one of the "perquisites of office that make it very difficult for challengers." AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH, FORUM 3, REGULATION OF POLITICAL CAMPAIGNS—HOW SUCCESSFUL? 4 (1977) [hereinafter cited as REGULATION OF POLITICAL CAMPAIGNS].

In late 1973, the Service took the position in Revenue Ruling 73-356 that payments received by an elected official to fund publication of a newsletter were includable in the gross income of the official.¹¹⁷ Although the IRS would permit the official to offset this income by taking deductions for publication expenses, significant accounting problems could arise concerning whether the deductions could be claimed in the same year in which the income would have to be reported.¹¹⁸ Moreover, officials claiming the standard deduction would lose the benefit of the publication deductions entirely. Under this ruling officials would have had to maintain detailed records that would be subject to IRS review. Ostensibly to alleviate these difficulties, Congress classified newsletter funds as tax-exempt political organizations,¹¹⁹ thus eliminating the inclusion of funds typically received for newsletters in candidates' gross income. Congress went further, however, taking this opportunity to classify such payments as contributions that qualified for the increased credit and deduction for political contributions.¹²⁰ Like the deduction-credit amendment, the provision also afforded a special dispensation to incumbents.¹²¹

¹¹⁷ Rev. Rul. 73-356, 1973-2 C.B. 31, 32. This treatment applied even if the funds were segregated and unreachable for campaign purposes. Although the Service did not provide a satisfactory rationale for this position, presumably it viewed such funds as available for the candidate's personal use and thus includable in his income. See note 10 *supra*.

¹¹⁸ Streng, *supra* note 2, at 163-64 & n.138. For a discussion of other potential problems, see H.R. Rep. No. 1502, *supra* note 45, at 111.

¹¹⁹ I.R.C. § 527(g).

¹²⁰ *Id.* § 41(a). Congress offered no satisfactory rationale for this step. The Senate Finance Committee explained rather disingenuously that "the governmental process is strengthened by encouraging such contributions. It is vital that citizens know what their elected public officials are doing in office, so the voters can evaluate their performance for future elections and can tell their officials what they want them to do and not to do." S. REP. NO. 1357, *supra* note 82, at 35, reprinted in [1974] U.S. CODE CONG. & AD. NEWS 7478, 7511. Of course, newsletters doubtlessly presented biased assessments of the official's performance. See note 116 *supra*. Moreover, Congressmen and other elected officials already enjoyed extensive franking and stationery allowances. The franking privilege allows members of Congress to send mail under their signatures without being charged for postage. In 1976 members sent 421.4 million pieces of franked mail, at a cost of \$51.8 million to taxpayers. The House passed a bill in 1977 that would place some restrictions on Congressmen's franking privileges. See H.R. 7792, 95th Cong., 1st Sess. (1977); 35 CONG. Q. WEEKLY REP. 1446 (1977). The Senate Governmental Affairs Committee amended the bill to increase Senate franking privileges, which traditionally have been narrower than House privileges. 36 CONG. Q. WEEKLY REP. 2698, 2698-99 (1978). See also REGULATION OF POLITICAL CAMPAIGNS, *supra* note 116, at 6 (comments of Prof. Ralph Winter alleging that the frank "costs more than challengers spend on an entire election-year campaign").

¹²¹ Theoretically, the newsletter fund tax benefits also are available to candidates for election to public office. See I.R.C. §§ 41(a), 41(c)(5), 527(g). The benefit, however, goes to

Prior to the 1974 legislation contributors in many cases had preferred to transfer appreciated property to political organizations. The traditional IRS view that the transfer constituted a gift meant that the contributor incurred no income tax liability for the donation. In addition, the political organization paid no tax when it disposed of the property, because Congress and the Service pursued a policy of de facto tax exemption for political organizations.¹²² Senator Alan Cranston, who introduced a bill¹²³ to close this loophole, estimated the resulting loss of tax on the appreciation at \$5 million for 1972 alone.¹²⁴

Senator Cranston's proposal sealed the loophole by taxing the contributor on the appreciation at the time the property was transferred to the political entity. Although the events precipitating the adoption of the Cranston position¹²⁵ at times resembled Senator Williams' exposés, more than intense political pressure motivated Congress to tax contributors on the appreciation of donated property. Soon after the introduction of the Cranston bill, the IRS had ruled that the political organization receiving appreciated property—not the contributor—would be subject to taxation.¹²⁶ Moreover, the Service planned to tax political organizations on *all* appreciation, including appreciation that had accrued before the donee organization received the property. This approach was consistent with the Service's view that the contribution of appreciated property constituted a gift: the political organization was required to take the donor's basis and to recognize gain, upon a subsequent disposition of the property, in an amount equal to the difference

contributors to officials not yet running for office, because the credit is available for newsletter fund contributions in years when campaign contributions are not being made.

¹²² See notes 22-25 *supra* and accompanying text.

¹²³ S.2332, 93d Cong., 1st Sess., 119 CONG. REC. 27469 (1973).

¹²⁴ *Id.*

¹²⁵ The Cranston proposal was enacted as part of the Upholstery Regulators Act, Pub. L. No. 93-625, § 13(a)(1), 88 Stat. 2108 (1975)(codified at I.R.C. § 84).

¹²⁶ Rev. Rul. 74-23, 1974-1 C.B. 17, 18; Rev. Rul. 74-21, 1974-1 C.B. 14, 16. See note 80 *supra* and accompanying text. The Service had acted after a year of review prompted by *The Wall Street Journal's* embarrassing disclosure of the appreciated property gambit. See Landauer, *supra* note 71. Within a week after the article appeared, the IRS announced that it would solicit comments in anticipation of hearings on the tax treatment of contributions of appreciated property. IRS, Press Release No. 1257 (Oct. 3, 1972). The Service's ruling, although retroactive, covered only sales of appreciated property made after October 3, 1972, thus permitting much of the gain realized by the Nixon and McGovern political committees to escape taxation. H. ALEXANDER, *supra* note 1, at 363. *But see* note 129 *infra*.

between the carryover basis with adjustments and the fair market value.¹²⁷

The Service's ruling would have imposed significant tax burdens on political organizations. In addition to imposing almost unavoidable income tax liability, the IRS position mandated full-scale reporting requirements for political organizations and ongoing IRS auditing and oversight of organization activities. Faced with this prospect, Congress opted for the Cranston proposal,¹²⁸ assuring at least that the tax burden would fall on the contributor.¹²⁹ The donee would take a stepped-up basis in the contributed property, which would produce a minimal tax liability if the organization followed the usual procedure of promptly disposing of the property for cash, and IRS involvement in the affairs of political organizations would be curtailed significantly.

C. *The New Role of the Service in Campaign Finance*

Congress responded in a superficial and predictable manner to the Service's efforts to impose a scheme of taxation on campaign

¹²⁷ The Service received position papers urging it to adopt a stance taxing the contributor rather than the donee. According to one theory, an implicit agreement existed between the parties, providing that the donee should sell the property for the donor. A second theory advanced the notion that the access to a candidate gained by making a contribution was a realization event. For a discussion of these responses to the IRS, see 23 CATH. U.L. REV. 322, 331-33 (1973). See also Note, *supra* note 9, at 34-35, discussing the administrative problems with the Service's approach. The most serious problem is that the likelihood of collecting tax from campaign organizations is slim because many committees are insolvent or defunct after the election. 23 CATH. U.L. REV. 322, 334 (1973). The Democratic National Committee, for example, had a \$9.3 million debt after the 1972 election. *Id.* at 331 n.41, 334.

¹²⁸ Senator Cranston had emphasized the potential "for harassing and possibly intimidating opposition political parties [through the use of audits]" if the political organization, rather than the contributor, were taxed upon the disposition of contributed appreciated property. 119 CONG. REC. 27469 (1973).

¹²⁹ I.R.C. § 84. Under § 84(a), the donor realizes an amount equal to the fair market value of the property transferred. Although the fair market value could be determined when the donee subsequently disposes of the property, Congress preferred to measure the value at the time the property is contributed. The contributor thus knows the extent of his income tax liability at the time of the contribution. H.R. REP. NO. 1502, *supra* note 45, at 110. As usual, gain is computed as the difference between the amount realized (in this case, the fair market value of the contributed property) and the adjusted basis of the property in the hands of the contributor. See I.R.C. §§ 1001(a), 1011, 1012, 1016.

Section 84 operates retroactively for transfers made after May 7, 1974. It has been suggested that saving the Nixon and McGovern campaign committees taxes on gain from appreciated property owed pursuant to certain revenue rulings was the primary motivation behind the legislation. See note 126 *infra*. As a result of the new law, the Nixon campaign saved an estimated \$500,000, and the McGovern campaign an estimated \$300,000, in taxes. H. ALEXANDER, *supra* note 1, at 363.

finance. Eager to enact specific provisions to counteract the Service's broad initiatives, the drafters failed to recognize the full implications of the new legislation. Although Congress succeeded in codifying an income tax exemption for political organizations, this statutory exemption represented a significant departure from the previous *de facto* exemption. The *de facto* exemption scheme essentially insulated all campaign finance from the income tax laws. In contrast, a statutory exemption would be available only upon explicit satisfaction of the prerequisites spelled out in the statute. Formal adherence to the statute would control, and the IRS alone would be responsible for assuring compliance with the law. Although granting tax exemption, the 1974 codification necessarily presaged IRS intrusion into the political process, at least to determine whether tax exemption would be permitted in particular cases.

The sponsors of the legislation also overlooked the problems inherent in translating legislative intent into law. Because the legislation lacked any clear expression of policy objectives,¹³⁰ considerable doubt arises regarding the meanings of operative terms. Regulations proposed by the IRS¹³¹ indicate that the Service, which has authority to promulgate regulations and to issue interpretive rulings,¹³² intends to take a major role in defining compliance with the statute. The statutory provisions that define political organizations, tax-

¹³⁰ Although a statement expressing the need to weigh loss of revenue against encouragement of political participation accompanied the legislation, Congress made no real inquiry into the balance. See note 82 *supra* and accompanying text.

¹³¹ The regulations were proposed on Nov. 24, 1976. 41 Fed. Reg. 51840 (1976). A notice of public hearing on the proposed regulations appeared in the Federal Register on Jan. 31, 1977. 42 Fed. Reg. 5704 (1977). The Service has received numerous comments on the regulations, most of which question the technical meaning of key terms. See Comments on Proposed Regulations to I.R.C. § 527, on file with the Virginia Law Review Association.

¹³² I.R.C. § 7805(a) provides that "the Secretary [of the Treasury] shall prescribe all needful rules and regulations for the enforcement" of the internal revenue laws. The regulations issued pursuant to § 7805(a) are interpretive in nature and carry great weight in court. See E. GRISWOLD & M. GRAETZ, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 46 (1976). Particular sections of the Code often grant additional authority. See, e.g., I.R.C. §§ 167, 385(a), 1502. These regulations have been described as being "legislative" in nature and as having the "force of law unless it could be shown that the regulations are unreasonable or beyond the power delegated to Treasury by the Congress." E. GRISWOLD & M. GRAETZ, *supra*, at 46. The Secretary of the Treasury in turn has delegated authority to issue regulations to the Commissioner of Internal Revenue, subject to the approval of the Assistant Secretary of the Treasury for Tax Policy. *Id.* at 47.

In addition to regulations, the Service issues interpretive rulings on the basis of a stated set of facts. Usually, rulings are issued in response to taxpayer requests for interpretation or clarification of tax provisions. The Service may publish the ruling or reply by letter to the inquiring taxpayer. See I FEDERAL INCOME TAXATION, *supra* note 6, at 59, 62.

exempt revenue from fundraising events, and expenditures giving rise to taxable income represent the more striking areas of legislative ambiguity inviting interpretive intervention by the IRS.

1. Political Organization

To qualify for tax exemption, an entity must be a "political organization."¹³³ A political entity that fails to qualify as a political organization may be subject to taxation on contributions and other receipts, even if the funds are used for admittedly political purposes.¹³⁴ Moreover, contributors are subject to gift tax on all transfers of money or property to an entity that is not classified as a political organization.¹³⁵ Failure to qualify very likely would result in seriously reduced funding, making competition with other political organizations difficult.

The new law defines a "political organization" capable of qualifying for tax exemption as an entity "organized and operated *primarily* for the purpose of directly or indirectly accepting contributions or making expenditures . . . for an exempt function."¹³⁶ An exempt function in turn is defined as "influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any Federal, State, or local public office or office in a political organization."¹³⁷ The statute, however, does not define the term "primarily," and the IRS clearly intends to retain considerable discretion in establishing the meaning of the word. For example, the proposed regulations provide that "[i]n making the determination of whether a political organization is 'organized and operated primarily to carry on an exempt function' all the facts and circumstances of each case shall be considered."¹³⁸

¹³³ I.R.C. § 527(a).

¹³⁴ The statute does not delineate the proper tax treatment of entities that do not qualify as political organizations. These organizations presumably would be subject to income taxation on contributions. See Golden, *supra* note 2, at 247-49.

¹³⁵ I.R.C. § 2501(a)(5) exempts from gift taxation only transfers to a political organization "within the meaning of section 527(e)(1)."

¹³⁶ I.R.C. § 527(e)(1) (emphasis added).

¹³⁷ *Id.* § 527(e)(2). See note 95 *supra*. This definition does not address political organizations that advocate a specific issue rather than support a particular candidate. Conversely, the breadth of the definition could bring within the scope of I.R.C. § 527 organizations that otherwise would be tax exempt under I.R.C. § 501, e.g., the League of Women Voters. See Streng, *supra* note 2, at 145-46.

¹³⁸ Proposed Treas. Reg. § 1.527-2(a)(4). The IRS has held that surplus campaign funds from an earlier campaign spent by a legislator to attend a political convention as a delegate were expended for an exempt function. The separate bank account in which the funds had

The proposed IRS regulations provide that, in the absence of "other relevant factors," an organization satisfies the primary purpose test if its articles of organization confirm that it was organized to carry on an exempt function.¹³⁹ The proposed regulations do not specify what additional factors will be considered relevant.¹⁴⁰ An organization may satisfy the primary purpose test notwithstanding the fact that it has no formal documents evidencing its formation, provided that it has not spent more than an "insubstantial" amount of money on nonexempt and nonqualifying activities. The proposed regulations identify qualifying activities as including those that "reasonably relate to the selection, nomination, or election of individuals for the next applicable political campaign." The terms "insubstantial" and "reasonably relate," however, are not defined.¹⁴¹ The IRS presumably will construe the meanings of these expressions.

2. Fundraising Events

Fundraising events—a traditional mainstay of campaign finance¹⁴²—recently have gained even greater prominence as candidates stage more performances by leading entertainers to encourage political contributions.¹⁴³ According to the Service's proposed regulations, the income from a fundraising activity that is "[s]ubstantially related to the exempt function" of the sponsoring organization will be tax-free.¹⁴⁴ To be "substantially related," a fund-

been kept qualified as a political organization. *See generally* Rev. Rul. 79-11, I.R.B. 1979-2, 8. In a second ruling, the Service held that expenditure of surplus funds from a previous campaign for voter research, polls, and canvasses was also an exempt function. Rev. Rul. 79-13, I.R.B. 1979-2, 9.

¹³⁹ Proposed Treas. Reg. § 1.527-2(a)(4).

¹⁴⁰ The proposed regulations do suggest that the ratio of expenditures used for an exempt function to total expenditures for all purposes is a "principle" relevant factor. *Id.*

¹⁴¹ Proposed Treas. Reg. § 1.527-2(a)(6). Recently, the Service ruled that a separate bank account in which a political candidate deposited campaign funds and then withdrew the funds for bona fide campaign expenses was a political organization. Rev. Rul. 79-11, I.R.B. 1979-2, 8.

¹⁴² In his classic work on campaign finance, Alexander Heard noted that "[o]f all the new contrivances devised since the First New Deal to meet the costs of politics, the fund-raising dinner is the most important." A. HEARD, *THE COSTS OF DEMOCRACY* 233 (1960). For an analysis of the fiscal importance and financial efficiency of fundraising dinners, see *id.* at 234-45.

¹⁴³ *See, e.g.,* N.Y. Times, May 4, 1972, at 30, col. 4 (describing Warren Beatty's lavish and successful fundraising dinners and benefit concerts for Presidential candidate George McGovern).

¹⁴⁴ Proposed Treas. Reg. § 1.527-3(b)(4)(i)(A). The fundraising event may not be carried on "in the ordinary course of a trade or business." Proposed Treas. Reg. § 1.527-3(b)(4)(i)(B).

raising event must have "a causal relationship to the achievement of the exempt function (other than through the production of funds) and [it is] substantially related for purposes of this section only if the causal relationship is a substantial one."¹⁴⁵ A substantial relationship will not exist "[w]here the activities do not contribute importantly to the exempt function."¹⁴⁶ The IRS has reserved for its own determination the meanings of "substantially" and "importantly," as well as the definition of the proper causal relationship: "Whether the activities productive of gross income contribute importantly to the accomplishment of the exempt function depends in each case upon the facts and circumstances involved."¹⁴⁷ Income exceeding that needed to carry on an exempt function will not be exempt when it is derived from activities "which are conducted on a larger scale than necessary for the performance" of an exempt function.¹⁴⁸ The Service has not specified what standards it will employ to determine what is "a larger scale than necessary." Whatever these terms mean, the Service clearly intends to make itself the arbiter of acceptable modes of staging fundraising events.

3. Expenditures Giving Rise to Taxable Income

In exempting political organizations from income taxation, the statute carefully limits the exemption to certain types of receipts: contributions, membership dues and fees, proceeds from political fundraising and entertainment events, and receipts from the sale of political campaign materials.¹⁴⁹ Funds derived from these sources must be segregated and used for an exempt function; all other income is subject to taxation.¹⁵⁰ The proposed regulations take the statutory limitation a step further, requiring each organization to report as gross income any income that would otherwise be exempt function income but that is expended for "making improvements or

¹⁴⁵ Proposed Treas. Reg. § 1.527-3(b)(4)(ii)(B).

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ Proposed Treas. Reg. § 1.527-3(b)(4)(ii)(C).

¹⁴⁹ I.R.C. § 527(c)(3). See note 95 *supra*. Section 527 incorporates the definition of "contribution" set forth in I.R.C. § 271(b)(2). I.R.C. § 527(e)(3).

¹⁵⁰ Political organizations' taxable income is defined in I.R.C. § 527(c)(1) as the excess of "(A) the gross income for the taxable year (excluding any exempt function income), over (B) the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income)." This general formula is subject to certain modifications. I.R.C. § 527(c)(2). A specific deduction of \$100 is allowed; however, no deduction is allowed under I.R.C. § 172 for a net operating loss or under part VIII of subchapter B, which provides special deductions for corporations. *Id.*

additions to its facilities or for equipment which are not necessary for or used in carrying out its exempt function.”¹⁵¹ The proposed regulations offer no guidance regarding which improvements, additions, or equipment will be deemed “necessary.” Thus at a time when the political campaign is undergoing a radical transformation into a highly scientific, sophisticated activity managed by professionals,¹⁵² the Service’s discretion over the taxation of campaign funds gives it considerable power to influence the scope and rate of that transformation.

D. The Service’s History of and Potential for Abuse of the Political Process

There is no inherent impropriety in the discretionary exercise of the Service’s power to promulgate regulations and to issue interpretative rulings to fill in the gaps that Congress left in a bareboned tax statute. The present statutory scheme is troubling, however, because it gives an extremely potent administrative agency the opportunity to affect directly the political process. Such power should not be accorded to any executive agency unless Congress has considered fully the consequences of the delegation and has inquired into alternative approaches that might involve less potential for intrusion into the political process.

The many well-established instances of IRS abuse suggest that the Service simply cannot withstand political pressure. For decades the Service failed to tax the income of political organizations, although no explicit statutory exemption existed. This is symptomatic of a chronic vulnerability to political pressure that raises questions regarding the Service’s ability to enforce the new law in a nonpartisan fashion.¹⁵³ The favorable private letter rulings issued to Democratic contributors in 1952 and the ruling on gift tax committees issued some twenty years later for the benefit of Republican contributors confirm that this political sensitivity favors no one political party, but rather has surfaced during administrations dominated by each major party. The assault on the Communist Party indicates the Service’s susceptibility to temptation to misuse the tax laws against fringe parties and candidates.¹⁵⁴

¹⁵¹ Proposed Treas. Reg. § 1.527-4(a)(1).

¹⁵² See note 57 *supra*. See also H. ALEXANDER, *supra* note 1, at 340-44.

¹⁵³ For a history of the Service’s contradictory and dissembling policy statements, see note 47 *supra*.

¹⁵⁴ The Service has attempted to impose tax liability selectively not only on the Communist

Indeed, one of the most troubling aspects of the new law is the legitimization of IRS involvement in the political process. Because the standards for determining tax-exempt status remain so vague, the Service reasonably can justify intrusive rulings by arguing that it merely is playing its proper and necessary role in interpreting the law. Although any political organization or candidate can challenge an IRS determination, the remedy has no value if fundraising efforts are stalled and an election is lost in the interim.

The tremendous authority of the Service will not be limited to taxation of candidates seeking federal office. The law applies to the political process at every level: national, state, and local.¹⁵⁵ Moreover, the statute is not restricted to electoral candidates but extends to funds received and expended in an effort to influence the appointment of an individual to public office.¹⁵⁶ This IRS involvement in campaign finance at every level of government fundamentally alters the electoral process in practical as well as theoretical ways. The

Party, but also on other political organizations. See notes 47-48 *supra*. Recently, the IRS has been used against noncandidate officials of the major political party that is out of power and against independent citizens who have criticized the party in power. See *Hearings Before the House Comm. on the Judiciary Pursuant to H. Res. 803—a Resolution Authorizing and Directing the Comm. on the Judiciary to Investigate Whether Sufficient Grounds Exist for the House of Representatives to Exercise its Constitutional Power to Impeach Richard M. Nixon, President of the United States*, 93d Cong., 2d Sess. 217-35 (1974) (detailing the repeated investigations of Democratic Party National Chairman Lawrence O'Brien ordered by White House aide John Ehrlichman); *id.* at 95-96, 102 (IRS harassment of persons listed on former President Nixon's "enemies list"). For a thorough consideration of executive attempts to use the IRS against political enemies, see *Center on Corp. Responsibility, Inc. v. Shultz*, 368 F. Supp. 863, 867 (D.D.C. 1973). See also *Tax Reform Research Group v. I.R.S.*, 419 F. Supp. 415 (D.D.C. 1976) (detailing specific documents and transcribed conversations concerning use of the IRS against selected taxpayers).

Apparently not only President Nixon attempted to politicize the Service. *E.g.*, V. LASKY, *IT DIDN'T START WITH WATERGATE* 55-58, 60-62, 132, 134-35, 139 (1977) (alleging similar manipulation of the IRS by Presidents Kennedy and Johnson). See B. BRADLEE, *CONVERSATIONS WITH KENNEDY* 218 (1975). See also *N.Y. Times*, May 8, 1974, at 1, col. 7. President Johnson allegedly used the IRS against Senator John Williams, who was responsible for eliminating the bad debt and advertising expense deductions in campaign finance. See notes 26-34 *supra* and accompanying text. According to Lasky, Senator Williams' efforts to expose the sordid dealings of Johnson's close associate Bobby Baker prompted the IRS harassment. See V. LASKY, *supra*, at 135, 139. Based on a meticulous audit of Senator Williams' tax returns, the Service determined that he actually was entitled to a refund. *Id.*

¹⁵⁵ See notes 133-41 *supra* and accompanying text.

¹⁵⁶ Some commentators have expressed concern that this provision will bring organizations that are not political in the narrow sense of the term within the scope of I.R.C. § 527. For example, activities of the National Association of Broadcasters supporting or opposing a candidate for appointment to the Federal Communications Commission could bring the organization within the scope of the § 527 definition of a political organization. See Streng, *supra* note 2, at 146.

proposed regulations would require every organization with an exempt fund to "maintain adequate records to allow the verification of receipts into and expenditures out of such fund."¹⁵⁷ The record requirement would open the most intimate details of every campaign to IRS scrutiny and would reveal the political affiliation of each contributor.¹⁵⁸ Maintaining sufficient records will impose a major additional cost on political organizations, in many cases requiring substantial accounting, legal, and clerical assistance.

III. CONCLUSION

The history of federal taxation of campaign finance is marked by Congress's self-serving determination to bar any restrictions on the free flow of funds to political campaigns. Congress initially accomplished this objective through a de facto exemption that effectively insulated the system of campaign finance from the vagaries of tax law as well as from the dangers of heavy-handed IRS enforcement.¹⁵⁹ Congress's early success in maintaining a tax-free system of campaign finance depended to a large extent on IRS cooperation, which Congress received despite the absence of a statutory exemption for campaign finance. During this period the Service had little interest in tangling with the legislators who control the agency's budget. In addition, the IRS felt only weak political pressure to enforce the tax laws.

¹⁵⁷ Proposed Treas. Reg. § 1.527-2(a)(3).

¹⁵⁸ Unlike the verification contemplated by the Service in regulations under I.R.C. § 41 (granting a credit for political contributions), the contributor here could not conceal his identity by choosing not to claim the income tax credit. Congress has enacted several broad disclosure provisions in connection with its regulation of campaign finance, but these provisions have been marked by constitutional and political controversy and have lacked effective enforcement machinery. See notes 52-53 *supra* and accompanying text. Thus, IRS auditing of political entities would represent a quantum leap in the federal government's capacity to cause mischief in the political process. Moreover, these deleterious effects would extend beyond federal elections to the state and local level. For a history of campaign finance disclosure and enforcement legislation, see D. ADAMANY & G. AGREE, *supra* note 1, at 83-115; Fleming, *Regulation of Campaign Financing*, 1976 ANN. SURVEY AM. LAW 649. For incisive views of the continuing political struggle to control the Federal Election Commission, the agency charged with enforcement of disclosure and contribution limitations in federal elections, see 37 CONG. Q. WEEKLY REP. 242 (1979); *id.* at 329; 36 CONG. Q. WEEKLY REP. 3109 (1978); *id.* at 1056; 35 CONG. Q. WEEKLY REP. 2522 (1977). States have encountered similar difficulties with disclosure. See generally CAMPAIGN MONEY: REFORM AND REALITY IN THE STATES (H. Alexander ed. 1976); Comment, *Loophole Legislation—State Campaign Finance Laws*, 115 U. PA. L. REV. 983, 985-89, 992-98 (1967).

¹⁵⁹ See notes 4-35 *supra* and accompanying text. Congress deviated from this pattern to enact remedial legislation on only two occasions, when it felt intense political pressure to eliminate patently abusive techniques. See notes 26-34 *supra* and accompanying text.

The system of de facto tax exemption finally collapsed when Congress's interest in stimulating campaign finance and the Service's concern with erasing public doubts about its integrity diverged. Congress substituted for the de facto exemption system a statutory scheme bearing the characteristics of congressional activity in this area of the law: the statute was a hastily drafted, poorly conceived agglomeration of disparate responses to the Service's efforts to restrict the free flow of campaign funds. Although Congress spoke of the need to strike a balance between the concern with assuring adequate financing for the political process and the concern with protecting tax revenue, the legislation as enacted safeguards neither of these interests. The provisions exempting contributors from gift taxation, and political organizations from income taxation, reduce government revenue.¹⁶⁰ In addition, the need to determine which contributors and organizations satisfy the statute's prerequisites for tax exemption—a determination made especially important because of the ambiguity of those requirements—virtually guarantees continuing IRS involvement in campaign finance.

Drafting a statute that adequately accommodates the often divergent goals of the federal taxation and campaign finance systems admittedly presents a difficult task. The interest in a tax-free system of campaign finance must be balanced against the inevitable loss of revenue.¹⁶¹ The legislature must confront difficult issues, including whether the tax laws should be used to subsidize and stimulate campaign finance¹⁶² and, if so, who should benefit from the

¹⁶⁰ Most political organizations have a life-span coterminous with the election. Even those organizations that operate past the election rarely have capital to invest. The current statutory framework thus may impose significant IRS intrusion on political organizations without any corresponding benefit from the augmented revenue flow. In this sense, the development is more troubling than recent legislation restricting the amount of contributions and requiring their public disclosure. See notes 111 & 158 *supra*. Limiting and disclosing contributions at least may encourage broader political participation and dilute the presumed power of wealthy contributors. Moreover, the agency charged with enforcing this legislation does not have the resources, expertise, or power to threaten the political process in the way IRS involvement does.

¹⁶¹ For example, it might be found that tax-exempt political organizations provide convenient tax shelters for contributors and candidates. In contrast, it might be concluded that there is little risk of abuse and that a complex statute involving considerable IRS oversight is unnecessary.

¹⁶² This particular concern goes to one of the fundamental debates in taxation: the extent to which the system can and should be "neutral." See generally Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970). For example, the check-off system actually may result in less public influence over candidates because funds are allocated entirely on past

subsidies and incentives¹⁶³ and how the laws should be implemented.¹⁶⁴ Drafters also must assess the extent of IRS involvement and the concomitant risks posed to the political process. Regardless of how these issues are resolved, it is necessary for Congress finally to confront them. The integrity of the political process is now at stake, and the time has come for a thoroughgoing debate to commence.

party performance and the law does not permit taxpayers to designate the candidate to whom the money will go. Despite the Supreme Court's failure to so hold in *Buckley v. Valeo*, 424 U.S. 1 (1976), *see note 55 supra*, the check-off system also appears to discriminate against third parties. *See, e.g.*, the especially harsh remarks of former Senator Eugene McCarthy, a 1976 independent Presidential candidate, in *REGULATION OF POLITICAL CAMPAIGNS, supra note 116*, at 2, 7-9, 14-17.

¹⁶³ A recent example of this problem is the deduction permitted for contributions to a newsletter fund or to a candidate in the year prior to the announcement of his candidacy, a provision that favors incumbents. *See notes 112-21 supra* and accompanying text.

¹⁶⁴ Tax laws do not always accomplish the intended objective. A recent example of this is David Adamany's finding that credits and deductions have not encouraged broad-based financing of the political process. *See Adamany, supra note 5*, at 4.