POLITICIANS, NONPROFITS, AND OPPORTUNITIES FOR PERSONAL ENRICHMENT

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In recent years, the debate over the role of money in politics has tended to focus on the potential for influence in the legislative process obtained by those who contribute funds to members of Congress or candidates for such offices. The debate has rarely focused on the potential for personal enrichment that might be present as well, perhaps because the idea of personal gain seems to fly in the face of commonly accepted notions of good government. Despite such public perceptions, personal gain remains a very real element of political campaign financial affairs. This paper will attempt to describe the potential for such use of campaign funds.

A broad array of rules are in place that restrict or prohibit the ability of members of the United States Congress to derive personal benefit from the immense fund-raising opportunities afforded by their incumbency.[1] This was not always the case. For example, Revenue Ruling 68-19[2] simply and directly stated that any campaign funds used

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1 While there is some history of illegal financial activity by members of Congress, the "Abscam" episode of the late 1970's being one example, this paper assumes an intention on the part of the members to remain within legal restrictions. No inference to the contrary is intended or should be drawn from references to individuals or organizations used to illustrate particular aspects of the regulatory framework.

2 1968-1 C.B. 810

by a candidate for personal purposes were to be taken into the candidate's income in the year in which the funds were so used. There were no limitations, restrictions or penalties on such a use of campaign contributions, indeed the revenue procedure goes so far as to suggest that all deductions allowable under the Internal Revenue Code might be available to soften the tax bite. The timing of distributions for personal use was at the whim of the candidate or incumbent. As late as 1992, it was still possible for incumbent members of Congress (those that had been in office on January 8, 1980) to convert campaign funds to personal use at the discretion of the member. Effective with the convening of the 103rd Congress in January, 1993, statutory restrictions such as those found in the Federal Election Campaign Act of 1971, as amended,[3] and the Ethics Reform Act of 1989,[4] coupled with ethics rules imposed on members by the Senate and House of Representatives, generally precluded personal use of political contributions by members. The only informal exceptions to the prohibition are expenses that have a *bona fide* nexus to political campaigning as well as a personal component, such as travel expenses.[5] The travel need not be to and from the relevant state or congressional district to establish the requisite nexus, but the purpose of the travel must be clearly political in nature rather than recreational.[6] For example, the House ethics rules, while stating that "as long as

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[3] 2 U.S.C. secs. 431-455.

[4] Pub. L. No. 101-194, 103 Stat. 1716 (1989).

[5] Supra note 2, at 6. The article contains a table drawn from campaign disclosure reports indicating that five House members bought cars, two Senators rented apartments in their home states, two members of Congress endowed academic chairs in their names, several members paid for country club memberships, and five House members bought tuxedos. No specific time frame was noted with regard to the expenditures, nor was the number of financial disclosure reports that were reviewed for the chart noted.

[6] Committee on Standards of Official Conduct, <u>Ethics Manual for Members, Officers, and Employees of the U. S. House of Representatives,</u>

Members do not convert campaign funds to personal use or official uses, they generally have wide discretion as to what constitutes a *bona fide* political purpose" also provide, as an example of an inappropriate use, payment for a Caribbean vacation to recuperate from "a particularly grueling but successful campaign." Such constraints effectively nullify the former *laissez faire* approach which is still reflected in section 527 of the Internal Revenue Code[7] which seems to assume eventual personal use of some amount of campaign funds. Regulations[8] issued under section 527, for example, which antedate the more recent constraining changes, set out procedures and provide examples of how such diversions should be treated for purposes of federal income tax, including an illustration involving the use of campaign funds to pay an individual's personal federal income tax liability.

The aforementioned constraints, however, have a temporal quality tied to incumbency. Once a member of Congress leaves that position, whether by resignation, retirement, or reelection defeat, the impact of the rules lessens dramatically. At the same time, however, the former member's fund raising prospects also decline. A premium[9] is thus placed on planning and a number of options are available.

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[7] All references to sections herein are to the Internal Revenue Code of 1986, unless otherwise indicated.

[8] Section 1.527-5(a)(1). All references to regulations are to the U.S. Department of the Treasury Income Tax Regulations, unless otherwise indicated.

[9] A possible example of the drop-off effect can be seen reflected in the 1998 and 1999 Forms 990 return of the Dole Foundation, an organization recognized as exempt from federal income tax under section 501(c)(3). The 1998 support schedule, Part IV-A, reflects strong contributor support in 1994 and 1995, years in which Robert Dole was a member of the Senate. Contributions drop dramatically beginning with the 1996 year and, by 1999, are virtually nonexistent, at which time the Foundation filed its final Form 990. Other explanations of the contribution pattern are possible, of course.

I. The Campaign Committee Option

An assumption must be made that, while still an incumbent, the member continued to actively solicit contributions for his or her duly authorized campaign committee within the rules administered by the Federal Election Commission. Assuming appropriate timing of the member's retirement announcement (well towards the end of the term but not so late that a replacement candidate can't be identified), the campaign committee may have considerable financial reserves. These "hard money" funds can be reprogrammed in several ways.[10]

Assuming that the former member no longer harbors plans for future political office and, thus, will not have a personal political campaign need, the campaign committee can be converted to a political action committee ("PAC"). The excess campaign funds, and valuable assets such as mailing lists, can then be transferred to the PAC and be available for use to support a second career as a lobbyist or other business activity that would be assisted by the ability to make political contributions.[11]

The range of exempt function activities for a PAC extends across the spectrum of legitimate campaign activities, and is not relegated to making financial contributions to

[10] "Hard money" political organizations are those subject to Federal Election Commission reporting and regulation. In contrast, "soft money" political organizations avoid the FEC rules by refraining from the express advocacy of a candidate's election or defeat. "Soft money" organizations were made subject to special Internal Revenue Service reporting and disclosure rules by P. Law 106-230 (July 1, 2000).

[11] Weiss, Stephen, "Legacy War Chests: What Happens To All That Money When A Lawmaker Leaves Office Or Quits A Race?" 7 Capital Eye 1 (June, 2000). The author discusses the conversion PACs and the lobbying/law practices of former Rep. Robert Livingston (R-La) and former Rep. Bill Paxon (R-NY).

particular candidates as if it was a political private foundation.[12] Both Federal Election Commission and Internal Revenue Service rules anticipate that PACs will incur reasonable expenses in carrying out their exempt function activities. Expenses for travel, food, and reasonable salaries for employees are all well within the scope of exempt function expenditures under section 527. The Internal Revenue Service has even issued a private letter ruling approving the payment of reasonable compensation to a candidate from his campaign committee.[13] The implication is that it would also be an appropriate exempt function expenditure to pay a reasonable salary to a former member who was providing services to a PAC. As long as a standard of reasonableness is observed and there is a firm nexus to political activities, the former member may undertake a role as "elder statesman," advising candidates and political parties, attending fund raising golf tournaments and convening discreet strategy sessions from Key Biscayne to Palm Springs. Expenses related to such matters, as well as a reasonable stipend for the former member to permit his or her active and continuous involvement, will likely be appropriate exempt function expenditures for the PAC.

The campaign committee option has several drawbacks, however, chief of which is that contributions are unlikely to continue past the announcement of retirement from Congress. There is no tax-based incentive for supporters of a political organization, other than an exemption from federal gift tax, to replace the appeal of political access. Funds will be necessary if activity is going to be sustained for any significant period of time

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[12] Id. at 2-3. The article notes that former Rep. Toby Roth (R-Wis.), now lobbyist Roth, who left office in 1996 and converted his campaign fund to a PAC, spent more than $4,200 on travel and meals in 1999, primarily in Appleton, Wisconsin, where the PAC is located, as well as making contributions to candidates.

[13] PLR 9516006 (January 10, 1995)

after departure from Congress. One option is to solicit contributions that are set aside in an investment account akin to an endowment. Unless carefully structured, however, this option has significant tax-related disadvantages as the investment or business income of political organizations is subject to federal income tax at the highest corporate rate.[14] Additionally, the act of investing itself is a tax event for the organization under the provisions of the regulations that tax the organization's expenditures when made for the purposes of deriving a direct or indirect financial benefit.[15] In order to avoid these complications, the campaign committee could solicit contributions in the form of municipal bonds, the interest from which is excluded from taxation, unlike other forms of political organization investment income.[16] Receiving contributions in the form of an investment interest such as bonds, rather than investing cash contributions in bonds, avoids the imposition of tax on expenditures for the "direct or indirect financial benefit" of the political organization.[17]

An additional drawback of this option is that, as a "hard money" PAC, the disclosure and reporting rules administered by the Federal Election Commission will continue to apply as will the limitations on sources and amounts of contributions. As all such FEC reports are audited by the FEC staff, conversion PACs will need to exercise care to ensure continuing compliance and avoid the possible imposition of fines and penalties.

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[14] Section 527(b)(1).

[15] Section 1.527-(5)(a)(1) of the regulations.

[16] See Kindell, Judith E. and Reilly, John F., "Election Year Issues," Exempt Organizations Continuing Professional Education Technical Instruction Program for 1993, Internal Revenue Service, 454.

II. The "Soft Money" Political Organization Option

As with the Campaign Committee Option, this option requires pre-retirement planning by the member. Under this option, while still a member of Congress and able to capitalize on fund raising, a "soft money" political organization should be formed under section 527 and Revenue Ruling 2000-49.[18] This particular type of political organization, as long as it avoids express advocacy of a particular candidate or coordination with a candidate, will generally avoid the Federal Election Commission regulatory regimen. A benefit of status as a "soft money" PAC is that the organization will not be subject to limitations to domestic sources of funds and on amounts of contributions.[19] The ability to solicit unlimited corporate contributions should facilitate fund raising during the incumbency period. A second benefit is that there will be no necessity to convert the organization from campaign committee status to PAC status upon retirement. The organization simply continues.

The same benefits regarding reasonable expenses will apply to the "soft money" political organization as they do to "hard money" political organizations. However, if the PAC intends to remain outside the FEC regulatory structure, care will have to be exercised to avoid activities that are sufficiently coordinated with a candidate or political party so as to trigger application of FEC rules. This may be accomplished by avoiding direct political campaign events and focus support and activities on issues in specific geographic areas targeted to impact particular elections. This would require some

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[18] I.R.B. 2000-44 (October 30, 2000).

[19] As with "hard money" PACs, contributions from foreign sources are prohibited by 2 U.S.C. 441e.

analysis to ensure linkage between personal travel preferences and politically significant issues. For example, issues of coastline development could have an impact on elections in San Diego County, California, Martha's Vineyard, and Hilton Head, South Carolina, necessitating considerable research and travel expense.

The "soft money" political organization will be subject to the same taxes on investment income as the "hard money" political organization discussed in the first option. Contributions in the form of tax-exempt bonds would have the same exclusionary effect with regard to interest income as well.

As the "soft money" political organization will not be subject to FEC jurisdiction, it need not be concerned with the high rate of FEC audit activity. The organization will need to comply with the IRS administered reporting and disclosure rules, however. On the other hand, given IRS resources and the scope of the agency's responsibilities, audit attention will be dramatically lower.

III. The Social Welfare Organization Option

This option necessitates creating a form of tax-exempt organization known as a social welfare or "advocacy" organization.[20] As with all the options, this organization should be created well before departure from Congress to ensure adequate funding as there is no tax-based incentive for contributors. In this case, the exemption from federal

[20] Section 501(c)(4).

gift taxes applicable to contributions to political organizations would not be available. It should be noted that both the House and Senate Ethics Rules prohibit lobbyists from contributing funds to tax-exempt organizations "maintained or controlled" by a member, relative, or employee. There appears to be no restriction relating to former business partners or friends; consequently, organizations formed and controlled by trusted third parties have the most flexibility with regard to fund raising.

There are no limitations on the sources or amounts of contributions to organizations exempt under section 501(c)(4), and sources can include corporate and foreign national donors (if the member, member's relatives, or employees have no involvement in the organizations). The names and addresses of contributors, while reported to the Internal Revenue Service, would not be made public, unlike either the first or second options. This could facilitate the corporate and foreign national support.

A benefit of this option is that the investment income of the organization is exempt from federal income tax, unlike the investment income of political organizations. Consequently, there is no need to consider soliciting contributions in the form of tax exempt bonds to avoid income tax on the interest. The exemption on investment income includes rents from real property.

As social welfare organizations may engage exclusively in lobbying activity, it could serve as a freestanding Washington base or affiliate for a related proprietary consulting firm exploiting the former member's Congressional experience.[21]

[21] A variation on this option seems to have been employed by former Rep. Newt Gingrich whose political committee, Friends of Newt Gingrich, filed a termination report with the Federal Election Commission reflecting a transfer of its funds remaining after satisfaction of debts (approximately $75,000) to the Committee for New American Leadership. The Committee is rather obliquely described in the report as a "nonprofit entity." Information gleaned from web sites <newt.org>, <gingrichgroup.com>, <SocialSecurityPlus.org>, <NoDeathTax.org>, <MaxTax.org>, and <NoNetTax.org> suggests that the

Social welfare organizations can pay reasonable compensation to employees, including reimbursement of reasonable expenses incurred in carrying out the organization's activities. Compensation does not have to be restricted to cash and could include use of automobiles, a residence, and similar benefits so long as the value is reasonable in light of the work performed and the amounts are treated on the organization's records as compensation paid. Some care should be taken in setting compensation levels, as those persons with "substantial influence" over a social welfare organization are subject to penalty excise taxes and correction requirements if excessive compensation or other "excess benefits" are received by them from the organization.[22]

IV. The Charity Option

From the standpoint of sustainability, the option of directly creating, or inspiring the creation by close associates of, a charity described in section 501(c)(3) has the greatest potential. Not only is there a tax-based incentive at the federal level in the form of the charitable contribution deduction to support such entities, but gifts are excludible from gift tax, and contribution deductions are likely available at the state level as well. There are no restrictions on the amount or source of contributions, including, as with section 501(c)(4) organizations, support from foreign nationals and corporations.

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organization intends to lobby Congress on issues similar to those of interest to the Gingrich Group, an Atlanta-based communications and management consulting firm.

[22] Section 4958.

As the example of the Dole Foundation suggests, the creation and operation of a charity during a member's term in Congress facilitates fund raising. Public support is essential to enable the charity to qualify as a public charity under section 509(a)(1) and section 170(b)(1)(A)(vi). This status, or similar public charity status under section 509(a)(1) or section 509(a)(2), is necessary to avoid the excise taxes and restrictions on private foundations in Chapter 42 of the Code. It is also necessary to qualify the organization to receive the assets of the member's campaign fund raising organization or other political organization.[23] The identification of charities as appropriate recipients of terminating political organizations is a major distinction and advantage over the social welfare organization option.

The requirement that the charitable recipient of a terminating political organization's funds be a public charity described in section 509(a)(1) or section 509(a)(2) carries with it the possibility that the charity, if dependent on popular identification with a member of Congress for its attractiveness to donors, might become a private foundation within a few years of the member's departure from Congress. Private foundation status would bring with it the restrictions on activities and relationships in Chapter 42 of the Code and the excise tax on net investment income in section 4940. Private foundation status, with its attendant prohibition on lobbying[24] and restrictions on reimbursement of government officials[25] would essentially eliminate the organization's usefulness as an adjunct to a lobbying or consulting practice. It would also preclude the sharing of expenses, facilities

[23] Section 1.527-6(a)(2)(b)(2) of the regulations.

[24] Section 4945(e)

[25] Section 4941(d)(1)(F), section 4941(d)(2)(F), and section 4941(d)(2)(g)

and assets, such as mailing lists, with related proprietary organizations (a lobbying firm owned by the former member, for example).[26] In order to avoid private foundation status, after receiving the political organization's assets, the public charity could convert to a supporting organization under section 509(a)(3). This entails amending the articles of incorporation or other governing document to reflect the supporting relationship towards a public charity (including a donor-advised fund or community foundation) or a publicly supported social welfare organization exempt under section 501(c)(4), labor union exempt under section 501(c)(5), or trade association exempt under section 501(c)(6).

The major restrictions on charitable expenditures are found in the Internal Revenue Code and secondarily under state law. The general principle governing expenditures to or for the benefit of individuals who are not, themselves, objects of charity is that the expenditures must be reasonable in light of the goods or services provided. Such expenditures can include reasonable compensation, both current and deferred, as well as reimbursement of reasonable expenses.[27] Compensation can include both taxable and excludable fringe benefits. Payment of excessive compensation, however, will jeopardize the continued exempt status of the charity as well as implicate the penalty excise tax on excess benefit transactions in section 4958.

If payment of compensation or the provision of other benefits to the member, his or her relatives, or employees occurs, Senate and House Ethics Rules preclude the

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[26] Section 4941(d)(1).

[27] An extensive discussion of the forms of compensation appropriate for employees of tax-exempt charities can be found in "Compensation," Exempt Organizations Continuing Professional Education Instruction Program for 1990, Internal Revenue Service, 171-233.

solicitation of contributions by the member, the relatives, or employees.[28] This restriction suggests that payment of such benefits should be avoided until the member leaves office and can assume the role of a director, officer or employee of the charity. In the interim, the member's involvement in the charity's activities and the public's identification of the member with the charity will generate favorable media exposure.[29] Nonpartisan issue-oriented fund raising using the imprimatur of the member also provides visibility and a mailing list. Fund raising letters or other methods of raising funds using references to the member, such as his or her signature, should avoid political messages, as section 501(c)(3) contains an absolute prohibition on political campaign intervention by charities. In addition, section 4955 of the Code contains a penalty excise tax on political campaign intervention by charities. Indeed, the Internal Revenue Service has recently made public a memorandum discussing the adverse impact on exempt status and the excise taxes in the context of fund raising letters signed by a political candidate on behalf of an educational organization. Use of the charity's mailing list was also an issue.[30]

The same halo effect of association with a charity that would have been present when the member was in office would continue after his or her departure, providing favorable media exposure.

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[28] E.g. Hansen, James V. and Berman, Howard L., Memorandum for All Members, Officers and Employees regarding "Rules governing (1) Solicitation by Members, Officers and Employees in General and (2) Political Fundraising Activity in House Offices." (April 25, 1997), summarizing the House Ethics Manual. Similar restrictions are found in the Senate Ethics Manual at pp. 76-77.

[29] See Chisholm, Laura Brown, "Sinking the Think Tanks Upstream: The Use and Misuse of Tax Law to Address the Use and Misuse of Tax-Exempt Organizations by Politicians," 51 U. Pitt. L. Rev. 577.

[30] TAM 200044038 (July 24, 2000)

V. The Trade Association Option

This option involves the creation of a trade association recognized as exempt under section 501(c)(6). This approach shares many of the characteristics of the social welfare option, including exemption of investment income from tax and a prohibition on inurement of income. Trade associations must be organized and operated to further the interests of a particular line of business and, as a result, are generally structured as membership organizations.[31] This requirement could limit the organization's attractiveness to donors outside the relevant industry. However, trade association status would tend to make membership dues and contributions more easily deductible as ordinary and necessary business expenses under section 162.

Section 501(c)(6) organizations, like section 501(c)(4) entities, are not considered appropriate recipients of political organization termination disbursements under section 527. Accordingly, support would come in the form of contributions and dues from businesses interested in supporting an organization that reflected a member's interests.

The section 501(c)(6) option would be most easily established using trusted friends rather than the member, his or her relatives, or employees. After the member's departure from Congress, it could continue to support a lobbying or law practice by. Assets developed during the member's term, such as mailing lists, could be made available to the proprietary enterprise as well.

[31] The Trade Association Option appears to have been the intended choice of the late Rep. Les Aspin, then Chairman of the House Armed Services Committee, who created the Aspin Procurement Institute, overseen by a former staffer, for the purpose of securing Department of Defense contracts for Wisconsin-based industry. See Hall, Andy, "Aspin Institute Rolls in Dough," Wisconsin State Journal (December 20, 1992).

VI. Conclusion

As the preceding discussion suggests, changes in federal tax and election law coupled with strengthened Senate and House ethics rules have effectively precluded the ability of incumbent members of Congress to benefit to a significant degree from the personal use of campaign funds. The discussion also makes it clear that a very different result obtains after the member has left office, particularly if a variety of organizations have been created by trusted friends and business associates to utilize proximity to the member as a fund raising device before the departure. There is evidence to suggest that all of the options have been known by the relevant parties for some time and, indeed, have been employed in various combinations. A study of the financial disclosure records of members of Congress conducted by the National Journal in 1989 revealed that 51 members of the Senate and 146 members of the House were founders, officers or directors of tax-exempt organizations.[32]

[32] Cohen, Richard E., and Matlack, Carol, "All-Purpose Loophole," National Journal, No. 49 (December 9, 1989).