Deductibility of Corporate Campaign Expenditures

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Summary

As the 2012 election cycle heats up, one question often asked is whether businesses may deduct amounts spent on political activities as a business expense. A related question is whether they may deduct dues paid to a 501(c)(6) trade association that then engages in such activities. These questions have greater significance in light of the Supreme Court's 2010 decision in *Citizens United v. FEC*, which struck down long-standing prohibitions in federal campaign finance law on corporations making certain types of campaign-related expenditures.

Section 162(e) of the Internal Revenue Code (IRC) generally prohibits corporations from deducting as a business expense the types of expenditures that they can now make post-*Citizens United*. The statute, which long predates the 2010 decision, prohibits taxpayers from deducting campaign-related and lobbying expenditures as a trade or business expense.

With respect to dues, the IRC generally permits a 501(c)(6) trade association to decide whether to notify its members of the portion of dues that are allocated to political activities and, therefore, not deductible. If the group provides the notification, then its members may not deduct that portion of the dues. If the group chooses not to provide the notification, or otherwise fails to do so, then it must generally pay a tax (known as a "proxy tax") on that amount. The notification and proxy tax requirements do not apply to any amount on which the 501(c)(6) organization is taxed under IRC Section 527(f). That section imposes a tax on 501(c) organizations that make an expenditure for influencing elections, among other activities.

Contributions to other types of tax-exempt groups that use the money for campaign activity would appear to be non-deductible under Section 162(e). It seems that donations to a Section 527 political organization engaged in electioneering, such as a political action committee (PAC, including a Super PAC), should not be deducted. The tax treatment of contributions to politically active 501(c) groups (e.g., 501(c)(4) organizations) may be a little more complicated, but it does appear that any amounts for campaign activity or lobbying should be non-deductible under Section 162(e). Nonetheless, some tax experts have recently suggested that businesses might be including some contributions to 501(c) groups in their marketing or advertising budgets and then deducting them as ordinary and necessary business expenses under Section 162. For anyone outside the IRS, determining whether this is actually happening would be very difficult, if not impossible, since the information is typically not publicly available.

Some have suggested that *Citizens United* calls into question the constitutionality of Section 162(e). The arguments appear to be that the tax code cannot disallow a deduction for activities that the Supreme Court has held are protected speech or provide beneficial tax treatment to only some types of speech (e.g., non-political business speech, the expenditures for which may be deductible). It is not clear this is true. Prior to *Citizens United*, the Supreme Court ruled that a regulatory provision similar to Section 162(e) was constitutional, explaining there is no requirement that the government subsidize a taxpayer's First Amendment rights by permitting a deduction for political expenditures. It is not at all clear that *Citizens United* changes this analysis. Therefore, until a court speaks to the issue, it seems premature to conclude that Section 162(e) is unconstitutional based on *Citizens United.*

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One question often asked after the Supreme Court's decision in *Citizens United v. FEC*,[1] which struck down prohibitions in the Federal Election Campaign Act (FECA) on corporations using their general treasury funds to make independent expenditures and electioneering communications, is whether businesses may deduct the amounts spent on these activities. Independent expenditures are communications "expressly advocating the election or defeat of a clearly identified candidate" that are not coordinated with any candidate or party.[2] Electioneering communications are broadcast, cable, or satellite transmissions that refer to a clearly identified federal candidate and are aired within 60 days of a general election or 30 days of a primary.[3] Post-*Citizens United*, corporations may now use their general treasury funds to make these expenditures directly, as well as to contribute to entities (e.g., Super PACs, trade associations, and 501(c)(4) groups) that engage in these types of activities. Notably, the federal ban on corporate contributions to political candidates and parties remains in effect.[4]

Disallowance of Deduction for Political Expenditures

Section 162(a) of the Internal Revenue Code (IRC) allows a deduction for "ordinary and necessary" business expenses. However, Section 162(e) generally prohibits taxpayers from deducting campaign and lobbying expenditures as a business expense. Specifically, Section 162(e), which has existed long prior to *Citizens United*, disallows a deduction for amounts paid or incurred in connection with

- influencing legislation (including bills, constitutional amendments, and public referenda and initiatives) through communication with a member or employee of a legislative body or a government official or employee who participates in formulating legislation;
- participation or intervention in any political campaign on behalf of or in opposition to a candidate for public office;
- attempts to influence the general public with respect to elections, legislative matters, or referenda; and
- any direct communication with a covered executive branch official in an attempt to influence his or her official actions or position.[5]

There are exceptions for local legislation and qualifying small amounts.[6]

[1] 130 S. Ct. 876 (2010). For analysis of this case, *see* CRS Report R41045, *The Constitutionality of Regulating Corporate Expenditures: A Brief Analysis of the Supreme Court Ruling in Citizens United v. FEC*, by (name red acted).

[2] 2 U.S.C. §431(17).

[3] 2 U.S.C. §434(f)(3).

[4] 2 U.S.C. §441b(a).

[5] IRC §162(e)(1)(A)-(D) and (e)(1)(4); IRC §4911(e)(2). Depending on the nature of the expenditures, other provisions of law may be relevant. *See, e.g.,* Treas. Reg. §1.276-1 (generally denying a deduction for certain advertising and entertainment expenditures that directly or indirectly finance political parties or candidates); Treas. Reg. §1.271-1 (generally denying a deduction for a worthless debt owed by a political party).

[6] IRC §162(e)(2) and (e)(4)(B).

Thus, when determining whether an expenditure is deductible, the first question is whether it qualifies as an "ordinary and necessary" business expense. An expense is generally treated as "ordinary" if it is not a capital expenditure[7] and "necessary" if it is appropriate for carrying on a trade or business or in the production of income.[8] If the expenditure meets this criteria, then the question becomes whether Section 162(e) disallows the deduction.

Absent Section 162(e), whether a campaign-related expenditure could qualify as an ordinary and necessary business expense would depend on the facts and circumstances of each case.[9] The following discussion analyzes whether any such expenditure could actually be deducted in light of Section 162(e).

Amounts Spent on Independent Expenditures and Electioneering Communications

While there is minimal interpretative guidance for these provisions, it appears that many, but perhaps not all, of the direct campaign expenditures that corporations may now make post-*Citizens United* would be non-deductible under Section 162(e) as either "participation in, or intervention in, any political campaign on behalf of (or in opposition to) any candidate for public office" or "an[] attempt to influence the general public, or segments thereof, with respect to elections."[10] It does not seem possible to argue that an activity which is an independent expenditure under FECA would fall outside these categories since such an expenditure, by definition, involves expressly advocating for or against a candidate.[11] In other words, independent expenditures appear to be per se campaign intervention under Section 162(e).[12]

Electioneering communications present a trickier situation. FECA defines them as broadcast, cable, or satellite communications that refer to a federal candidate and are made within 60 days of a general election or 30 days of a primary.[13] The IRC does not have an analogous bright-line standard for determining whether communications that merely refer to a candidate are campaign intervention. Rather, it appears that making this type of determination for tax law purposes requires looking at the facts and circumstances of each case to assess whether the communication

[7] *See* Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955).

[8] *See* Comm'r v. Tellier, 383 U.S. 687 (1966).

[9] *Cf.* Stern v. United States, 436 F.2d 1327, 1330 (5th Cir. 1971) (holding a business owner's political contributions, made with the goal of electing candidates who would create a more favorable business environment in the state, were not gifts because they were made in the "ordinary course of business" since "[t]he transactions in controversy were permeated with commercial and economic factors" and "motivated by appellee's desire to promote a slate of candidates that would protect and advance her personal and property interests" and, therefore, "[i]n a very real sense, ... [the taxpayer] was making an economic investment that she believed would have a direct and favorable effect upon her property holdings and business interests ....").

[10] IRC §162(e)(1)(B) and (C).

[11] 2 U.S.C. §431(17) (defining "independent expenditure" as an expenditure by a person that expressly advocates for the election or defeat of a clearly identified candidate and is not made in cooperation with or at the suggestion of such candidate).

[12] *Cf.* Judith E. Kindell and John Francis Reilly, *Election Year Issues*, IRS 2002 EO CPE TEXT, 346-49 (2002) (stating it is inappropriate for the IRS to use campaign finance law's "express advocacy" standard in interpreting the campaign intervention prohibition in IRC Section 501(c)(3) because the tax statute's language encompasses more than that). The language in Section 501(c)(3) and Section 162(e)(1)(B) are similar.

[13] 2 U.S.C. §434(f)(3)(A).

indicates a preference for or against the candidate, with the communication's timing being one factor to consider.[14] Due to this intersection between tax and campaign finance law, it seems possible that an issue advocacy communication might, depending on its timing and content, be an electioneering communication under FECA, but not be treated as campaign intervention under the IRC. Such a communication, nonetheless, may still be non-deductible due to the lobbying provisions in Section 162(e) (e.g., an issue advocacy communication linked to legislative matters would appear to be non-deductible even if there were a question as to whether it should be characterized as campaign activity).

Dues to 501(c)(6) Trade Associations

It is common for businesses to pay dues or make similar payments, primarily to trade associations that have federal tax-exempt status as 501(c)(6) organizations.[15] While these payments are generally deductible as a trade or business expense,[16] special rules apply when the 501(c) group engages in lobbying or campaign activities.[17]

In that situation, the tax consequences depend on whether the 501(c) entity provides its members, at the time the dues are assessed or paid, with a "reasonable estimate" of the portion of dues that are allocable to those activities.[18] If the group provides the notification, then its members are unable to deduct that portion of the dues.[19] If the group chooses not to provide the notification, or otherwise fails to do so, then it must pay a tax (known as a "proxy tax") on the amount of non-deductible dues.[20] The proxy tax is imposed at the highest corporate rate, which is currently 35%.[21]

The notification and proxy tax requirements do not apply to any amount on which the 501(c)(6) organization is taxed under IRC Section 527(f).[22] That section imposes a tax on 501(c)

[14] *Cf.* Rev. Rul. 2007-41, 2007-1 C.B. 1421 (discussing factors the IRS will look at when determining whether an issue advocacy communication has crossed the line into election activity for purposes of the 501(c)(3) campaign prohibition); Rev. Rul. 2004-6, 2004-1 C.B. 328 (discussing similar factors for purposes of the tax imposed on 501(c) organizations for engaging in certain political activities). Examples of the relevant factors include, in addition to the communication's timing, such things as whether the candidate's position has been raised (either by it or elsewhere) to distinguish him or her from other candidates; whether the communication is part of an ongoing series of substantially similar advocacy communications by the organization on the same issue; and whether the communication is connected to a non-electoral event (e.g., an upcoming legislative vote).

[15] IRC §501(c)(6) (describing "Business leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues ... , not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual").

[16] IRC §162(a) (generally permitting a deduction for "ordinary" and "necessary" business expenses).

[17] IRC §162(e)(3); IRC §6033(e). *See also* Rev. Proc. 98-19, 1998-1 C.B. 547 (explaining that Section 6033 applies to only certain types of 501(c) organizations). Under federal tax law, 501(c) organizations may not have engaging in campaign activity (and any other non-exempt purpose activity) as their primary purpose. For further discussion of the political restrictions imposed on 501(c) organizations, see CRS Report RL33377, *Tax-Exempt Organizations: Political Activity Restrictions and Disclosure Requirements*, by (name redacted).

[18] IRC §6033(e)(1)(A)(ii). In general, the expenditures are treated as paid out of the dues and, if they exceed the dues, the excess is carried over to the next year. IRC §6033(e)(1)(C). The organization may also be subject to tax if it underestimates the amounts.

[19] IRC §162(e)(3).

[20] IRC §162(e)(3); IRC §6033(e)(1)(A)(ii) and (e)(2).

[21] IRC §6033(e), IRC §11.

[22] IRC §6033(e)(1)(B)(iii).

organizations that make an expenditure for "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."[23] The 527(f) tax is imposed at the highest corporate rate (35%) on the lesser of the organization's net investment income or the total amount of taxable expenditures. When the tax is based on the organization's net investment income, this means the full amount of the organization's taxable expenditures was not taxed under Section 527(f). As a result, the 501(c) organization may still be subject to the notification and proxy tax requirements for the non-taxed amount.[24] Also, since the 527(f) tax generally does not apply to lobbying activities, amounts spent for these purposes are subject to the notification and proxy tax requirements.

Contributions to 527 and 501(c) Organizations

Contributions to tax-exempt groups that use the money for campaign activity would appear to be non-deductible under Section 162(e).

First, it would seem that any donation to a Section 527 political organization engaged in electioneering, such as a political action committee (PAC, including a Super PAC), should be non-deductible. By law, political organizations must be primarily organized and operated to "influence the selection, nomination, election, or appointment" of an individual to public office, an office in a political organization, or as a presidential or vice-presidential elector.[25] It seems difficult to argue that a donation to a group whose primary purpose is engaging in campaign activity would fall outside the scope of Section 162(e).

The tax treatment of donations to politically active 501(c) organizations (e.g., 501(c)(4) social welfare organizations) may be a little more complicated. Unlike political organizations, the 501(c) organizations allowed to engage in campaign activity may not have it be their primary activity.[26] In other words, they must engage primarily in other types of activities, and these could fall outside the scope of Section 162(e) (although it should be noted that many of these groups engage in substantial amounts of lobbying, which is covered by the provision).

While some payments to 501(c) organizations may qualify as "ordinary and necessary" business expenses, any amount for campaign activity or lobbying should be non-deductible under Section 162(e). Nonetheless, some tax experts have recently suggested that businesses might be including some contributions to 501(c) groups in their marketing or advertising budgets and then deducting them as ordinary and necessary business expenses.[27] For anyone outside the IRS, determining whether this is actually happening is very difficult, if not impossible, because the necessary

[23] IRC §527(e)(2).

[24] *See* IRS Internal Revenue Manuel 7.27.12.2.1, 7.27.12.3 (05-21-2003).

[25] IRC §527(e).

[26] *See* CRS Report RL33377, *Tax-Exempt Organizations: Political Activity Restrictions and Disclosure Requirements*, by (name redacted).

[27] *See* Jonathan Weisman, *Scrutiny of Political Nonprofits Sets Off Claim of Harassmet,* NY TIMES, March 6, 2012, available at http://www.nytimes.com/2012/03/07/us/politics/irs-scrutiny-of-political-groups-stirs-harassment-claim.html?pagewanted=all (reporting that, according to noted tax-expert Professor Frances Hill, some tax professionals suspect that businesses may be deducting contributions to 501(c) groups as part of their marketing or advertising budgets).

information is generally not publicly available.[28] Corporations are generally not required to disclose their tax returns, and, even if they did, such information might not be readily apparent from the return. Thus, unless a business discloses the deduction through some other means, it is not clear the general public would be able to discover whether any are deducting these amounts.

Constitutionality of IRC Section 162(e)

Some have suggested that the Supreme Court's analysis in *Citizens United* might raise questions about whether IRC Section 162(e) is constitutional. The arguments appear to be that the tax laws cannot disallow a deduction for activities that the Supreme Court has held are protected speech or provide beneficial tax treatment to only some types of speech (e.g., non-political business speech, the expenditures for which may be deductible). As discussed below, the Supreme Court upheld the constitutionality of a provision similar to Section 162(e), and it is not clear *Citizens United* would impact that analysis.

Congress has broad powers to tax under the Constitution.[29] In general, tax distinctions and classifications are constitutionally permissible so long as "they bear a rational relation to a legitimate governmental purpose."[30] The rational basis standard is a low level of review by a court. In the tax context in particular, courts typically show great deference in recognition of "the large area of discretion which is needed by a legislature in formulating sound tax policies."[31] At the same time, not all exercises of Congress's taxing power receive such deference. Sometimes, tax provisions are subject to higher levels of scrutiny. For example, tax provisions based on the content of speech are, like non-tax provisions, subject to strict scrutiny.[32] A provision subject to this highest level of scrutiny must be necessary to serve a compelling government interest and be narrowly drawn to achieve that end.[33] This is a heavy burden for the government to meet.

The decision by Congress to deny a deduction for certain business expenses, while allowing a deduction for others, appears to be well within its broad taxing powers and subject to minimal review by a court. As the Court has explained, deductions of trade or business expenses "may, to be sure, be disallowed by specific legislation, since deductions, are a matter of grace and Congress can, of course, disallow them as it chooses."[34]

It might, nonetheless, be argued that a more rigorous analysis should apply when, as here, a deduction is disallowed for expenditures related to the exercise of a constitutional right. However, the Supreme Court has held there is no requirement for the federal government to subsidize the constitutional rights of taxpayers. In *Cammarano v. United States*,[35] the Court upheld the validity

[28] *See, e.g., id.* (reporting that Professor Hill said, "I think the story here is that we have a system in which we think this is happening, and there's absolutely no way we can find out legally.").

[29] U.S. CONST. art. I, §8, cl. 1 ("The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises ....").

[30] Regan v. Taxation with Representation of Washington, 461 U.S. 540, 547 (1983).

[31] *Id*. at 547 (internal quotations omitted).

[32] *See* Arkansas Writers. Project, Inc. v. Ragland, 481 U.S. 221 (1987) (striking down a state sales tax that taxed general interest magazines, but exempted newspapers and religious, professional, trade, and sports magazines).

[33] *See id.* at 231.

[34] Comm'r v. Tellier, 383 U.S. 687, 693 (1966) (*quoting* Comm'r v. Sullivan, 356 U.S. 27, 28 (1958)).

[35] Cammarano v. United States, 358 U.S. 498 (1959).

of a tax regulation (in effect prior to IRC Section 162(e)) that disallowed a business deduction for lobbying expenditures. The taxpayers had been denied a deduction for amounts paid to a professional organization to lobby against a state initiative that would have had dire consequences for their business. They argued the disallowance violated the First Amendment, relying on a previous case, *Speiser v. Randall*.[36] In *Speiser*, the Court had struck down a state property tax exemption that required taxpayers to take a loyalty oath on the grounds that the state's tax administration procedures did not afford adequate due process. In striking down the provision that was clearly "aimed at the suppression of dangerous ideas," the Court emphasized its chilling effect on the proscribed speech and equated it to a fine for engaging in that type of speech.[37]

In *Cammarano*, the Court rejected the claim that *Speiser* was controlling, reasoning that the nondiscriminatory disallowance of a deduction for lobbying expenditures was different because, unlike the provision in *Speiser*, it was not intended to suppress dangerous ideas.[38] Instead, the Court explained, the taxpayers "are not being denied a tax deduction because they engage in constitutionally protected activities, but are simply being required to pay for those activities entirely out of their own pockets, as everyone else engaging in similar activities is required to do under" the tax laws.[39] The Court further explained that the disallowance "express[ed] a determination by Congress that since purchased publicity can influence the fate of legislation which will affect, directly or indirectly, all in the community, everyone in the community should stand on the same footing as regards its purchase so far as the Treasury of the United States is concerned."[40]

In a subsequent case, *Regan v. Taxation With Representation of Washington*,[41] the Court addressed a similar issue in upholding the federal tax law that limits the lobbying of Section 501(c)(3) organizations to "no substantial part" of their activities. The Court rejected the argument that the limitation infringed on the organization's First Amendment rights.[42] Rather, the Court, noting it had held in *Cammarano* that the First Amendment does not require the federal government to subsidize lobbying, explained that "Congress has merely refused to pay for the lobbying out of public moneys" and stated that it "again reject[s] the notion that First Amendment rights are somehow not fully realized unless they are subsidized by the State."[43]

The above subsidization analysis would seem to apply to Section 162(e), which is similar to the regulation at issue in *Cammarano*. Using such an analysis, a court would likely find Section

[36] Speiser v. Randall, 357 U.S. 513 (1958).

[37] *Id*. at 519 (internal quotations omitted).

[38] *See Cammarano*, 358 U.S. at 513.

[39] *Id*.

[40] *Id*. In a concurring opinion, Justice Douglas explained that if Congress had denied all business expense deductions to taxpayers spending money to lobby, then that would be placing a penalty on the exercise of First Amendment rights. *See id*. at 515 (Douglas, J., concurring) ("Deductions are a matter of grace, not of right.... To hold that this item of expense must be allowed as a deduction would be to give impetus to the view favored in some quarters that First Amendment rights must be protected by tax exemptions. But that proposition savors of the notion that First Amendment rights are somehow not fully realized unless they are subsidized by the State. Such a notion runs counter to our decisions ... , and may indeed conflict with the underlying premise that a complete hands-off policy on the part of government is at times the only course consistent with First Amendment rights.").

[41] Regan v. Taxation With Representation of Washington, 461 U.S. 540 (1983).

[42] *See id.* at 546. The Court also noted the organization had the option to set up a separate Section 501(c)(4) organization that could engage in the lobbying activities.

[43] *Id*. at 545-46 (internal citations omitted).

162(e) to be constitutional. It is not clear that *Citizens United* changes this conclusion. The Court's holding in *Citizens United* does not expressly address the constitutionality of Section 162(e). Any argument that the decision suggests Section 162(e) might be an unconstitutional burden on free speech appears debatable in light of the subsidization rationale expressed in *Cammarano*. In other words, it is not at all clear the holding in *Citizens United* that the government may not ban corporations from engaging in certain political speech requires the government to subsidize that speech. Furthermore, there might be some question as to the extent to which a court would extend the *Citizens United* analysis, in which the Court found the government's anti-distortion, anti-corruption, and shareholder protection concerns insufficient to support the ban on corporate political speech,[44] to Section 162(e), which does not prohibit speech or distinguish among taxpayers based on corporate status. Thus, until a court speaks to the issue, it seems premature to conclude that Section 162(e) is unconstitutional based on *Citizens United.*

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[44] *See, e.g., Citizens United*, 130 S. Ct. at 899 ("the Government may commit a constitutional wrong when by law it identifies certain preferred speakers"); 130 S. Ct. at 903, 907 (while prior case law had "found a compelling governmental interest in preventing the corrosive and distorting effects of immense aggregations of wealth that are accumulated with the help of the corporate form and that have little or no correlation to the public's support for the corporation's political ideas" [internal quotations omitted], this "antidistortion rationale [is] all the more an aberration" since "[t]he purpose and effect of this law is to prevent corporations, including small and nonprofit corporations, from presenting both facts and opinions to the public."); 130 S. Ct. at 908 ("Limits on independent expenditures ... have a chilling effect extending well beyond the Government's interest in preventing quid pro quo corruption. The anticorruption interest is not sufficient to displace the speech here in question.").