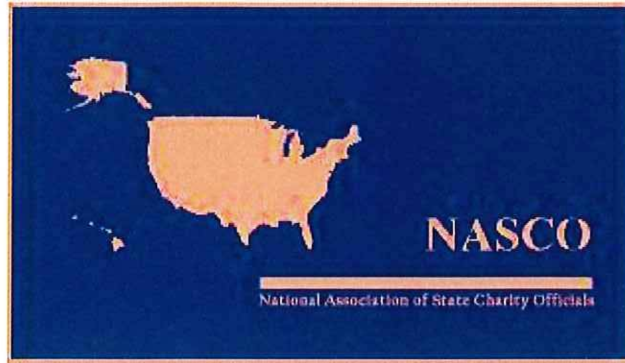

December 5, 2019

Internal Revenue Service
CC:PA:LPD:PR (REG-102508-16)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: IRS REG-102508-16 – Comments on the Proposed Regulation Eliminating a Schedule B Requirement for Tax-Exempt Organizations to Submit the Names and Addresses of Substantial Contributors

Dear Sir or Madam:

The National Association of State Charity Officials ("NASCO")[1] respectfully submits this comment letter in response to the request for comments in REG-102508-16, issued by the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") on September 6, 2019 under section 6033 of the Internal Revenue Code ("Code"). The preamble to the proposed rulemaking asserts that submission of the "names and addresses" of substantial contributors to tax-exempt organizations (other than IRC 501(c)(3) organizations) is not necessary for the efficient administration of the Code. On the contrary, as detailed below, IRS collection of the "names and addresses" of substantial contributors through Form 990, Schedule B is critical to the enforcement of the Code and state enforcement of complementary state laws regulating certain 501(c)(4)s that are public charities.[2] If the IRS moves forward in relieving 501(c)(4)s of the obligation to submit Schedule B, it will effectively abdicate enforcement with respect to those organizations, signal increased opportunity to abuse 501(c)(4) status and substantially increase the enforcement burden shouldered by state charity regulators. Therefore, and

[1] NASCO is affiliated with the National Association of Attorneys General ("NAAG") and serves as a forum for state charity officials to exchange views and experiences related to the regulation of public charities as well as to foster interstate cooperation regarding charitable enforcement efforts. NASCO members include representatives from state attorney generals' offices furthering their exclusive common law role to represent the public interest in preventing the misuse of charitable assets, breaches of fiduciary duty in the administration of public charities, and fraudulent and deceptive charitable solicitation.

[2] Many state charity regulators oversee 501(c)(4)s, which may be public charities under state law if their primary purpose is not political advocacy. *See* MODEL PROTECTION OF CHARITABLE ASSETS ACT (2011) at 13, *available at* https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=55198f6f-6c9d-feb0-6115-481d8c29cbee&forceDialog=0("Nor does the Act apply to organizations whose primary purpose is political advocacy. *Workmen's Circle Educational Center of Springfield v. Board of Assessors*, 314 Mass. 616, 619, 51 N.E.2d 313, 316 (1943)").

for the following reasons, NASCO urges the IRS to withdraw the proposed regulation or, at a minimum, to maintain the requirement to submit Schedule B for 501(c)(4) organizations.

I. The IRS Needs Schedule B Contributor Information to Spot "Red Flags" that can Alert the IRS to Examine an Organization for Code Violations

IRS commentary in the preamble to the proposed rulemaking asserts that the IRS can fulfill its enforcement functions without Schedule B because tax-exempt organizations will still be required to substantiate the number of contributors and amounts of their contributions. However, that information, without details identifying specific donors and their specific contributions, is not sufficient to guard against many kinds of fraud and illegal activity, as described more fully below. Nor is the IRS correct in asserting that it can obtain adequate compliance information from Form 990, Schedule L reporting of contributor loans, transactions and excess benefit transactions. Schedule L requires reporting only about transactions *between* contributors and the exempt organization – not information about all substantial contributors.[3]

Moreover, contributor information found in Schedule B can provide a "red flag" to alert the IRS (and state charity officials) to examine certain tax-exempt organizations. The IRS claims that it can request contributor information when it conducts an examination of a particular tax-exempt organization. But often it is the contributor information itself, cross-checked with other information contained in the Form 990 schedules, that creates a road map that helps "obtain a complete picture of [the] charities' operations" and "flag suspicious activity, simply by using information already available to the IRS." *Citizens United v. Schneiderman*, 882 F.3d 374, 382 (2d Cir. 2018).[4] As noted by the Supreme Court, fraud, by its nature, is often revealed not by a single smoking gun but by a pattern of suspicious behavior that "[l]ike a jigsaw puzzle" must be pieced together from "many pieces of evidence that, taken singly would show comparatively little." *Andresen v. Maryland*, 427 US 463, 482 (1976).

a. The Schedule B Road Map Can Identify Excess Benefit Transactions

By requiring disclosure of the names and addresses of substantial contributors and cross-checking this information with information contained in other Form 990 schedules, the IRS (and state charity officials) can observe patterns of suspicious behavior. This "road map" of behavior is essential to protecting the public from self-dealing and other excess benefit transactions. In conjunction with other information contained in Form 990 schedules, the Schedule B enables the discovery of the following types of illegal conduct, among others: (1) diversion of contributed and ostensibly charitable assets to either personal use or an improper use through or by the charity; (2) "self-dealing" by passing money through the charity to family members (who may not be "interested persons" who would appear in other schedules such as Schedule L); and (3) funding of enterprises that are created for the donor's own benefit

[3] Moreover, Schedule L also relies on honest and informed self-reporting, which is presumably in short supply for tax-exempt organizations that are seeking to skirt their legal obligations.

[4] While the court opinions in *Americans for Prosperity Foundation v. Becerra*, 903 F.3d 1000 (9th Cir. 2018) (*petition for cert. filed*, Aug. 6, 2019) and *Schneiderman*, 882 F.3d 374 (2d Cir. 2018) dealt with First Amendment issues regarding mandatory Schedule B reporting by 501(c)(3) and 501(c)(4) organizations to California and New York, both courts' constitutional analyses incorporated fact-finding about the necessity of the Schedule B reporting to those states' effective law enforcement. Such fact-finding about the necessity of Schedule B reporting for law enforcement is directly pertinent to IRS assertions about the need for Schedule B reporting for effective IRS enforcement of the Code.

A third state, New Jersey, also requires mandatory Schedule B reporting. N.J.A.C. 13:48-4.3, -5. Other states which do not compel filing of the Schedule B have subpoenaed the Schedule B directly from tax-exempt organizations as part of law enforcement investigations.

and not for a public charitable purpose. Accordingly, "[k]nowing the source and amount of large donations can reveal whether a charity is . . . doing business with an entity associated with a major donor." *Schneiderman*, 882 F.3d at 382.

For example, the Attorney General of California relied on Schedule B "road maps" in investigating several instances of violation of California charity laws including: the identification of self-dealing in a charity serving animals after Hurricane Katrina; the identification of "a charity's founder as its principal contributor, indicating he was using the research charity as a pass-through;" and the tracking of "a for-profit's use of a non-profit organization as an improper vessel for gain." *Americans for Prosperity Foundation v. Becerra*, 903 F.3d 1000, 1011 (9th Cir. 2018) (*petition for cert. filed*, Aug. 6, 2019).

b. The Schedule B Road Map Can Identify Sham Tax Exempt Organizations

The Schedule B "road map" also enables the identification of businesses that are operating as tax-exempt organizations, but in reality are reporting service payments as "contributions." The proposed rule inhibits the IRS's ability to identify such sham tax-exempt organizations. For example, a business organized under the guise of a tax-exempt organization might receive income by means of "contributions." If the IRS had access to the names and addresses of the organization's "contributors," it could determine whether those persons in fact paid a fee for the business's services rather than making charitable contributions. The IRS could thereby conclude that tax-exempt status is inappropriate.

c. The Schedule B Road Map Can Identify Impermissible Practices in Connection with Political Activities and Donations Involving 501(c)(4)s

The proposed rule will further degrade transparency around so-called "dark money" 501(c)(4) organizations that spend money to influence elections. 501(c)(4) status is appropriate for organizations whose purposes and activities are designed to promote social welfare causes, including political activities, but only so long as those organizations' primary purposes are not political.[5] Enforcement issues can arise when 501(c)(4) organizations contribute to other 501(c)(4) organizations. For example, if a 501(c)(4) spends less than 50 percent of its resources on political activities, but it donates its remaining funds to another 501(c)(4) organization to support that second organization's political activities, then essentially all of the first organization's funding would be used for political activities—which would exceed the legal limits for complying with its 501(c)(4) status. Therefore, IRS knowledge of the donor organization's identity (from the second organization's Schedule B, under current rules) would be essential in determining whether it was complying with tax law, or whether it was instead abusing tax exemption and 501(c)(4) status. The proposed rule change would seriously diminish the IRS's ability to identify this kind of impermissible conduct.

The IRS commentary asserts that Schedule L of the Form 990 provides sufficient contributor information, making Schedule B information unnecessary. However, Schedule L provides significantly less information than currently required in Schedule B. Schedule L requires organizations to provide information on certain financial transactions or arrangements *between* the organization and disqualified person(s) (such as substantial contributors) or other interested persons. Schedule L could therefore only provide red flags that result from a tax-exempt organization *giving* money (or some other benefit) to a donor. For example, Schedule L might report a situation where a CEO allows a 501(c)(4) to rent an

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[5] See Lindsey McPherson, *EO Training Materials Suggest 51 Percent Threshold for Social Welfare Activity*, 2014 TAX NOTES TODAY 13–15 (Jan. 21, 2014) (suggesting that, while the 501(c)(4) "primary purpose" test is ambiguous, IRS staff calculate the meaning of "primary" as requiring that 51% of a 501(c)(4)'s expenditures be for exempt, non-political activities).

office space from a donor-founder for well above fair market value. However, Schedule L would not catch the red flag in the example described above, where a 501(c)(4) involved in politics receives a donation from another 501(c)(4) involved in politics, because that transaction does not involve a financial benefit to the donor organization and therefore would not be reported on Schedule L.

d. The Schedule B Road Map Can Identify Fundraising Fraud

The Schedule B "road map" also facilitates the identification of organizations that misstate their purposes to the public. The Schedule B serves the government's interest in preventing tax-exempt organizations "from using donations for purposes other than those they represent to their donors and the public." *Schneiderman*, 882 F. 3d at 382. It achieves this by helping trace funds used for improper purposes. For instance, the California Attorney General's Office used the Schedule B to trace funds used for improper purposes in connection with a charity serving animals after Hurricane Katrina. *Americans for Prosperity*, 903 F. 3d at 1011.

e. Schedule B Can Identify Inflated In-Kind Donations

The Form 990 requires disclosure of the type and value of any in-kind gifts. This information, read in conjunction with the "road map" created by Schedule B, allows detection of schemes commonly referred to as "gift-in-kind scams," which are an organization's "intentional [ ] overstate[ment of] the value of noncash donations in order to justify excessive salaries or perquisites for its own executives." *Schneiderman*, 882 F.3d at 382. Further, by inflating the value of goods donated to it, an organization can distort its financial success or the size and scope of its operations and mask high fundraising and administrative costs that appear to be a smaller percent of overall expenses than they actually are. As a result, 501(c)(4) tax-exempt organizations are more likely to avoid scrutiny from the IRS and state charity regulators for excessive compensation and other inurement. Eliminating the Schedule B donor information will make identification of this kind of scheme more difficult.

II. Having Access to Donor Information Makes the IRS More Efficient

By requiring the routine disclosure of the names and addresses of substantial contributors, the IRS maintains the records of possibly suspicious activity on hand, which, during any ensuing investigation of a 501(c)(4) tax-exempt organization, avoids potentially harmful delays in obtaining pertinent contributor information. As noted above, this quick access to Schedule B filings increases regulators' "investigative efficiency" and allows them to "flag suspicious activity." Nor could the IRS effectively wait and request a Schedule B from a regulated entity after an investigation began, as the IRS would want to look at the Schedule B the moment an issue arose. *Americans for Prosperity*, 903 F.3d at 1009. Furthermore, the IRS's subpoenaing or sending a request letter to a suspect tax-exempt organization would "tip them off" to an investigation, which would allow the suspect organization to potentially dissipate or hide assets and destroy documents. *Id.*

IRS commentary in support of the proposed regulation also states that the Schedule B requirement of annual reporting increases compliance costs for affected organizations and consumes IRS resources. Yet, even under the proposed rule, 501(c)(4) tax-exempt organizations will still be required to incur costs to comply with IRS record-keeping requirements; they will avoid only the comparatively minor costs of recording names and addresses, from those records, in Schedule B. Further, the investigational inefficiencies created by the proposed changes will result in increased investigation costs for the IRS (and state charity officials) when they investigate an organization and are forced to request and process the same information that otherwise would have been reported on Schedule B.

III. Regulatory History Shows that Congress and the IRS Have Long Considered Contributor Information Necessary for Enforcement of the Code

The IRS, by asserting that there is no longer a need to disclose the identities of substantial contributors to tax-exempt organizations, seeks to countermand a regulatory requirement that has been in effect since 1971. The proposed regulation also flies in the face of the legislative history of the Code and the IRS's implementing regulations.

The legislative history of the Code shows that the drafters considered contributor information necessary to enforce the Code. Through the enactment of the Tax Reform Act of 1969, the IRS began requiring that all organizations exempt under IRC 501(c)(3) report the names and addresses of "substantial contributors," who are disqualified persons under self-dealing rules. In reviewing the bill for enactment, the Committee on Ways and Means explained that the new reporting requirement was "intended to facilitate meaningful enforcement of the limitations imposed by the bill." H.R REP. NO. 91-413, pt. 1, at 224 (1969).

This same enforcement rationale also applied to the IRS's promulgation of a 1971 regulation that required all other tax-exempt organizations to report the names and addresses of their contributors. That regulation states that 501(a) tax-exempt organizations "shall provide the names and addresses of all persons who contributed, bequeathed, or devised $5,000 or more." 36 Fed Reg 11025 (Jun. 8, 1971); *see* T.D. 7122, 488 Treas. Dec. Int. Rev. 137 (1971) (amending 1.6033-2(ii)(f)).

Moreover, the significance of contributor reporting requirements was underscored by 1996 Intermediate Sanctions legislation, 26 U.S.C. § 4958 (1996), and its IRS implementing regulations. That legislation imposes penalty excise taxes where organizations exempt from tax under IRC Sections 501(c)(3) or 501(c)(4) (other than private foundations) engage in an "excess benefit transaction." In such cases, Intermediate Sanctions may be imposed on certain disqualified persons who improperly benefit from an excess benefit transaction and on organization managers who participate in such a transaction knowing that it is improper.

The IRS's Intermediate Sanctions regulations define "disqualified persons" as those "in a position to exercise substantial influence over the affairs of [the] tax-exempt organization." Among the facts and circumstances that, per the IRS regulation, tend to show that a person has substantial influence – and thus is a "disqualified person" – is whether the person has been a "substantial contributor" within the five years preceding the transaction in question. *See* 26 C.F.R. § 53. 4958-3(e)(2) (2002).

In addition, according to House Report 104-506 (104th Cong., 2d Sess. 58 (1996)), which introduced the Intermediate Sanctions legislation, changes to the then-current IRC Sections 501(c)(3) and 501(c)(4) were necessary to: (1) ensure that the advantages of tax-exempt status ultimately benefit the community and not private individuals; and (2) "*enhance the oversight and public accountability of nonprofit organizations through additional reporting of information by nonprofit organizations to the Internal Revenue Service (IRS) and increased public access to documents filed by such organizations with the IRS.*" H.R REP. NO. 104-506, at 1179 (emphasis added). Specifically, 501(c)(3)s and 501(c)(4)s are required to disclose on their Form 990 "such information with respect to disqualified persons as the Secretary of the Treasury may prescribe." *Id.* at 1183.[6]

[6] This includes information required by the Treasury not only with respect to "excess benefit transactions," but also any other excise tax penalties paid during the year through excess lobbying expenditures, disqualifying lobbying

The position the IRS takes in the preamble and in putting forth this proposed rule – that it has no need for identifying information about substantial contributors – flies in the face of this legislative history compelling additional reporting about disqualified persons, the IRS's Intermediate Sanctions regulations defining "substantial contributors" as disqualified persons, and the IRS's prior, lengthy regulatory history requiring the reporting of substantial contributors.

In light of the foregoing, NASCO respectfully urges the IRS to withdraw the proposed regulation eliminating the Schedule B requirement for non-501(c)(3) tax-exempt organizations, and, at a minimum, to maintain the Schedule B reporting requirement for 501(c)(4) organizations. We appreciate your consideration of these comments and look forward to responding to whatever questions you may have.

Respectfully submitted,

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National Association of State Charity Officials

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expenditures, or political expenditures—"including the amount of the excise tax penalties paid with respect to such transactions, the nature of the activity, and the parties involved." H.R REP. NO. 104-506, at 1183.