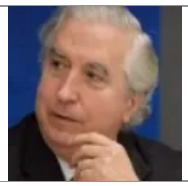

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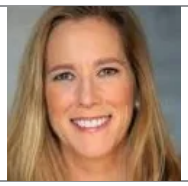

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Skadden Discusses Shadow Canvassing by 501(c)(4) Organizations

By Ki Hong, Tyler Rosen, Theodore Grodek and Alexa Santry February 6, 2025

Comment

Nonprofits organized under Section 501(c)(4) of the Internal Revenue Code (IRC) play an ever-growing role in politics and public policy advocacy. This is especially the case following the publication of the Federal Election Commission's Advisory Opinion 2024-01 (available here), which allowed a state PAC (and by its reasoning would also allow a 501(c)(4) organization) to engage in certain canvassing activity that was coordinated with federal candidates and national party committees without causing it to be an impermissible in-kind (*i.e.*, non-monetary) contribution. As a result of their newly found ability to coordinate such canvassing and possibly other types of communications, the demand for 501(c)(4) donations has significantly increased. These 501(c)(4) organizations may accept unlimited corporate and personal donations and are often used to engage in lobbying activity, issue advocacy, or political activity, such as through independent expenditures to support or oppose a candidate. What makes them so appealing is that (except under a handful of state laws, such as New York's disclosure requirement for a 501(c)(4) that makes independent expenditures) donors to these organizations need not be disclosed. However, the following discusses at a high level several potential legal hazards that companies and individuals should consider before establishing a 501(c)(4):

- **Maintaining Tax Status:** Under the Internal Revenue Code (IRC), a 501(c)(4) is a nonprofit organization with a mission to engage in "social welfare" activities benefitting the public good. It is not allowed to be used as a vehicle to directly benefit the business interests of the company that establishes it. The courts have not been clear as to the precise level of social or community benefit the organization's activity must engender to overcome any resulting benefit to the company. To mitigate this risk, one could take steps to separate the 501(c)(4) from the establishing company. Possibilities include, but are not limited to, ensuring the company is not the sole source of the 501(c)(4)'s funding and/or having outside representation on the 501(c)(4)'s governing board. One could also vet the nonprofit's activities to ensure that there is a strong position that they serve a social welfare interest.In addition, 501(c)(4) organizations are prohibited from engaging primarily in political activity, *i.e.*, attempts to influence an election of a candidate for federal, state or local office. In contrast, a 501(c)(4) may engage in unlimited lobbying or issue advocacy for the public good. Whether political activity is a 501(c)(4)'s primary purpose is determined by evaluating its political expenditures as a percentage of its total spending. The exact limit is a continuing topic of debate, but it must be below (and most likely significantly below) 50%.

  However, in a recent ruling, *Memorial Hermann Accountable Care Organization v. Commissioner of Internal Revenue*, the Fifth Circuit Court of Appeals (citing the Supreme Court's reversal of *Chevron* deference in *Loper Bright)* signaled a departure from the foregoing standard. In particular, the court stated that 501(c)(4) status can be denied even if the 501(c)(4) spends a mere "substantial" amount on non-exempt activity instead of it having to be its primary activity. Although this case did not involve political activity, such activity qualifies as non-exempt. A similar "substantial" standard is used in determining how much a 501(c)(3) public charity may spend on lobbying activity, which one court has opined could be as low as five percent.

- **Linkage:** 501(c)(4) activity that benefits a public official and is linked with a particular government action may form the basis of a federal prosecution under the "honest services fraud" provision of the federal mail and wire fraud statute. 18 U.S.C. §1346. As applied by prosecutors and courts, an honest services fraud violation can result even if there is no express *quid pro quo* agreement; rather, mere evidence suggesting a link between a benefit, such as a donation of effort made by the 501(c)(4) benefitting a public official, and the official performing an official act, can suffice. The linkage risk is heightened if a public official has input into or control over the 501(c)(4)'s spending, is involved in its governance, or is intended to receive a benefit from its activities. Thus, a company establishing or running a 501(c)(4) must carefully consider any connection the organization or its activities will have with a public official.

- **Public Reporting and Dark Money:** In a small minority of jurisdictions, such as New York and Connecticut, a 501(c)(4) may be directly required to publicly disclose its donors if it makes political expenditures or engages in lobbying. However, most other jurisdictions do not have such disclosure laws.Nevertheless, an illegal dark money issue could arise if the 501(c)(4) engages in activity where it has to publicly disclose its own activities. For example, if the nonprofit hires a lobbyist, most if not all jurisdictions require the lobbyist to disclose the nonprofit as the client, and in many cases require the nonprofit to separately file client reports. Similarly, there are ubiquitous requirements under which the nonprofit has to file reports disclosing its independent expenditures supporting or opposing candidates. Similar dark money concerns can arise if the 501(c)(4) contributes to an entity, such as a super PAC, that is required to disclose its donors. In both scenarios, to the extent the nonprofit is used as a mere conduit through which the company engages in reportable activity to avoid disclosure, it could be viewed as an attempt to cause a misrepresentation or fraud on the public record, and when giving to a super PAC, also a violation of prohibitions on making a contribution in the name of another.Indeed, the Department of Justice has shown a willingness to prosecute such dark money cases. In the 2022 case *U.S. v. Fuentes-Fernandez*, the president of a super PAC allegedly established 501(c)(4) organizations through which contributions were conduited to the super PAC. He also texted contributors, "You can use a third party to not disclose the true donor." Fuentes-Fernandez pleaded guilty to scheming to falsify campaign finance reports.This dark money risk is another reason to take steps to separate the 501(c)(4) from the company establishing it, as described in the foregoing section on "Maintaining Tax Status." The more separation there is, the more difficult it is to claim that the nonprofit is merely acting as a conduit. It is also important that the 501(c)(4) not accept donations where there is an understanding with the donor that the funds will be transferred to an entity subject to a requirement to disclose donors, such as to super PACs.

- **Campaign Finance:** Although 501(c)(4) organizations that solely make independent expenditures to support or oppose candidates are not subject to contribution limits, a 501(c)(4) that coordinates certain activities with candidates or parties, or otherwise makes a political contribution, could be subject to prohibitions or limits on corporate contributions. Moreover, it could also trigger a ban on the nonprofit accepting corporate contributions. Thus it is important for a 501(c)(4) organization to establish policies and procedures to avoid impermissible coordination and also comply with applicable disclosure or disclaimer requirements when making independent expenditure communications.

- **Pay-to-Play:** Donations to a 501(c)(4) organization are not directly covered under either the federal pay-to-play rules that cover certain financial institutions (*i.e.*, Securities and Exchange Commission Rules 206(4)-5 and 15Fh-6, Municipal Securities Rulemaking Board Rule G-37, Commodity Futures Trading Commission Rule 23.451, and Financial Industry Regulatory Authority Rule 2030) or the state and local pay-to-play rules that cover any government contractor, because these rules generally apply to political contributions. However, given that 501(c)(4)s can engage in a significant amount of political activity, as described above, donating to them could raise issues under the "indirect" provision of the federal rules and under the state/local rules that have a similar provision prohibiting the making of indirect political contributions. It is recommended that companies subject to such pay-to-play rules vet the 501(c)(4)s to which they contribute to ensure they do not violate such "indirect" provisions.

Many of the foregoing issues also arise when merely donating to, as opposed to establishing or running, a 501(c)(4) organization. These include concerns regarding linkage, dark money if there is an understanding that the nonprofit will transfer the donor's funds to a super PAC, campaign finance and pay-to-play. However, as a mere donor one is generally not expected to exercise the same level of diligence as if one were involved in establishing or governing the organization. Indeed, a donor may in most cases address these risks by vetting how the money was raised and obtaining certain representations from the nonprofit regarding the types of activities in which it engages.

At this point it is clear that 501(c)(4) organizations are here to stay as part of the political and public policy advocacy landscape, and can be a useful tool. Because of their growing prevalence and several high-profile instances of their misuse, 501(c)(4) organizations are frequently scrutinized by the media, regulators, and prosecutors. Whether one is considering establishing or merely donating to a 501(c)(4) organization, it is important to do so with care.

This post comes to us from Skadden, Arps, Slate, Meagher & Flom LLP. It is based on the firm's memorandum, "Shadow Canvassing by 501(c)(4) Organizations and the Rules Governing Their Activities."

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