New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 249—NO. 53
WEDNESDAY, MARCH 20, 2013

Outside Counsel

Expert Analysis

Piercing the Political Veil: Disclosure of Corporate Spending

By **Jerry H. Goldfeder**

And **Neal D. Richards**

As the 2012 presidential election vividly demonstrated, the magnitude of political expenditures unleashed in the wake of the Supreme Court's *Citizens United* decision can exert a powerful influence on the political process.[1] Not only can corporations and other large organizations muster huge sums of money to support their political causes, they can do so anonymously, through the use of tax-exempt 501(c)(4) and 501(c)(6) organizations that have no obligation to disclose the ultimate sources of their funds. This landscape has left many voters dissatisfied, leading several public officials of varying levels of government to take steps to ensure greater transparency of political expenditures.

Despite the constitutional bar on limiting expenditures themselves, it is widely thought that shedding light on corporate expenditures will result in a more informed electorate, reduce the potential for corruption of the political process, and help ameliorate the damage some believe has resulted from the absence of independent expenditure caps.

State and Local Efforts

Efforts to demystify anonymous contributions have been initiated at the state and local levels, as well as by Congress and federal agencies. Campaign regulatory agencies in New York, including the State Board of Elections,[2] the Joint Commission on Public Ethics,[3] and New York City's Campaign Finance Board,[4] have responded to the existence of anonymous expenditures by promulgating or proposing regulations to require disclosure by non-profits of their political spending. Recently, Attorney General Eric Schneiderman and State Comptroller Thomas DiNapoli weighed in on this issue, and in very different ways.

Attorney General's Proposed Regulations. Schneiderman has argued that the post-*Citizens United* world of unlimited campaign spending, especially anonymous spending, is a grave threat to our political system and risks corrupting the election process.[5] In particular, Schneiderman singles out 501(c)(4) "social welfare" groups as symptomatic of these troubles.

To combat this problem, the Attorney General's office proposed regulations that would require nonprofit groups registered with the state to disclose the percentage of their expenditures that relate to federal, state and local electioneering, including issue ads.[6] Furthermore, groups that spend at least $10,000 annually to influence New York state and local elections would be required to file itemized schedules of their expenses and contributions. Such disclosures would be released to the public. We await the issuance of Final Regulations.

New York State Common Retirement Fund Sues Qualcomm. Earlier this year, DiNapoli employed

JERRY H. GOLDFEDER *is special counsel at Stroock & Stroock & Lavan, and teaches election law at Fordham Law School and the University of Pennsylvania Law School. He is the author of "Goldfeder's Modern Election Law" (New York Legal Publishing Corp., Third Ed., 2012).* NEAL D. RICHARDS *is an associate at Stroock.* JASON S. VINOKUR, *an associate at the firm, assisted in the preparation of this article.*

an alternative approach to obtain disclosure, which may spread far beyond the borders of New York State. As sole trustee of the New York State Common Retirement Fund (one of the nation's largest public pension funds), the comptroller recently brought a lawsuit in the Delaware Court of Chancery against Qualcomm Inc.—the Common Retirement Fund is a large shareholder in Qualcomm—seeking disclosure of Qualcomm's political contributions.[7] The Fund had previously made a formal disclosure request to Qualcomm, but was rebuffed. Under Section 220 of the Delaware Corporation law, after a public corporation refuses a request from a shareholder to provide disclosure, a shareholder may seek to compel that corporation to allow inspection of its books and records relating to its use of corporate resources.[8]

The disclosure request to Qualcomm and subsequent Section 220 suit present an interesting new justification for disclosure of corporate political spending: shareholder value. Although prior legislative and regulatory efforts to shed light on political spending have generally focused on the political and ethical justifications, the new financial tack is more pragmatic and, consequently, may have broader appeal. Shareholders have a clearly defined interest in ensuring the profitability of an enterprise. When a significant portion of corporate funds are being used for political purposes, shareholders may legitimately question whether such expenditures support the profitability and growth of the enterprise.

In late February, Qualcomm settled the case and disclosed its contributions to tax-exempt organizations.[9] Given this success, it is likely that other shareholders, including officials responsible for other pension funds, will file similar actions against other companies. In a publicly traded company, virtually any political contribution might run afoul of the personal political preferences of at least one shareholder. Derivative suits by such shareholders, alleging the impropriety of such contributions, could have a counterproductive economic effect, as corporations would be compelled to expend precious resources responding to them. The quick settlement of the suit leaves us without judicial precedent, but it is not hard to imagine that others will employ this tactic in the future. Undoubtedly as a result of the lawsuit, Comptroller DiNapoli has been successful in persuading other companies to disclose their campaign contributions as well.

Efforts to demystify anonymous contributions have been initiated at the state and local levels, as well as by Congress and federal agencies.

Federal Efforts at Regulation

Unlike the numerous state and local agencies that have ad-dressed these issues, there has not been as much activity at the federal level. Moreover, many of the previous attempts at federal regulation have been unsuccessful. For example, Senator Charles Schumer's proposed DISCLOSE Act,[10] which would have limited the anonymity of those making independent expenditures, failed to garner sufficient support. Still, members of Congress continue to propose alternatives to deal with anonymous election spending.[11]

Furthermore, the SEC is (and has been) under significant pressure to regulate in this area.[12] Many have urged the Securities and Exchange Commission to issue new regulations regarding disclosure of political expenditures.[13] In 2012, on the Friday before Christmas weekend, the SEC posted an agenda item, without a press release, stating, "The Division is considering whether to recommend that the Commission issue a proposed rule to require that public companies provide disclosure to shareholders regarding the use of corporate resources for political activities."[14] Though the likelihood of SEC action is unclear, the agenda item raises the possibility that the SEC may require public companies to itemize their political expenditures on their annual or quarterly reports.

If the SEC decides to regulate, it would not be the first time it has dealt with corporate involvement in political affairs. In 2010, the SEC promulgated Rule 206(4)-5,[15] which aimed to crack down on "pay to play" practices of public pension advisors making political contributions to attract business. Rule 206(4)-5 addressed this potential problem by banning pension advisors from collecting fees for administering public pensions if certain key employees contribute more than a de minimis amount to a state or local employee who may be in a position to influence the selection of investment advisors. The SEC reasoned that such rules were necessary to prevent the distortion of the markets,[16] and could employ a similar rationale to regulate inde-

pendent political expenditures by public companies.

The Tax Men Cometh

In addition to the SEC, the IRS has indicated that it may take steps toward demanding transparency of 501(c)(4)s and other exempt organizations engaging in political advocacy. In the summer of 2011, the IRS began estate and gift tax audits of certain large contributors to political 501(c)(4) organizations.[17] As a result of either political pressure or a change in strategy, the IRS quickly withdrew the audits.[18]

The Attorney General's office proposed regulations that would require nonprofit groups registered with the state to disclose the percentage of their expenditures that relate to federal, state and local electioneering, including issue ads.

The 2012 election, however, has prompted some to call on the IRS to challenge the tax-exempt status of organizations engaging in political activity,[19] arguing that they do not primarily fulfill a "social welfare" purpose as required under the Internal Revenue Code.[20] A successful challenge to 501(c)(4) status could subject the organization to corporate income tax,[21] severely limiting its ability to conduct further business. Perhaps in response, the IRS Exempt Organizations Division's 2013 Workplan suggests that the IRS is indeed renewing such efforts.[22]

A significant obstacle to IRS investigations, however, is the timing for filing returns by 501(c)(4) organizations. Although 501(c)(3) organizations are required to apply to the IRS for exempt status,[23] a formal application for exemption by 501(c)(4)s is optional.[24] As a result, a 501(c)(4) organization, especially one whose status may be subject to question, may avoid a formal filing and merely submit tax returns as an exempt organization. Moreover, an organization created to influence a specific election may have already been dissolved by the time its first return is filed, leaving the IRS with no assets from which to collect tax. Despite these obstacles, successful challenges by the IRS to the 501(c)(4) status of advocacy groups might reduce the ability of such groups to use 501(c)(4) status to cloak their activities.

Against this backdrop, 2013 could be a watershed year for corporate political expenditure disclosure.

1. *Citizens United v. FEC*, 558 U.S. 310 (2010); see also *Am. Tradition P'ship. v. Bullock*, 132 S. Ct. 2490 (2012) (applying the holding of *Citizens United* to state law). Independent expenditures are expenditures "by a person for a communication expressly advocating the election or defeat of a clearly identified candidate that is not made in cooperation, consultation, or concert with, or at the request or suggestion of, a candidate, a candidate's authorized committee, or their agents, or a political party committee or its agents." See Federal Election Campaign Laws 11 C.F.R. §100.16 (2003). Expenditures that are coordinated with candidates or candidate committees are constitutionally subject to contribution limits.

2. The state BOE's independent disclosure regulations went into effect on Oct. 24, 2012. N.Y. Comp. Codes R. & Regs. tit. 9, §6200.10 (2012). These regulations described the procedures entities must follow when making independent expenditures.

3. On Jan. 15, 2013, J-COPE's regulations relating to source of funding disclosure for lobbying activity went into effect. N.Y. Comp. Codes R. & Regs. tit. 19, §§938.1-938.11 (2013). Notably, 501(c)(4) organizations are generally required to disclose their funding sources under these regulations, though they can request an exemption if they can show "harm, threats, or reprisals." N.Y. Legis. Law §1-j(c)(4) (2013).

4. On March 15, 2012, the CFB issued final rules regulating independent expenditures. CFB Rule 13-10 et seq. For more detailed information about the CFB regulations, see Jerry H. Goldfeder, "Big Spenders Beware: New York City Campaign Finance Board Is Watching," *New York Law Journal*, May 1, 2012.

5. Eric Schneiderman, "Restoring path of true democracy," POLITICO, Jan. 2, 2013, available at http://www.politico.com/story/2013/01/restoring-path-of-true-democracy-85688.html.

6. The proposed regulations will add a new section 91.6 to title 13 of the New York Codes, Rules and Regulations. Current N.Y. Comp. Codes R. & Regs. tit 13 §§91.6-91.12 will be renumbered §§91.7-91.13. The full text of the proposed regulations is available at http://www.ag.ny.gov/sites/default/files/press-releases/2012/Text_of_Proposed_Rule.pdf.

7. *New York State Common Ret. Fund v. Qualcomm*, No. CA8170 (Del. Ch. 2013).

8. Section 220(b) authorizes shareholders "to inspect the corporation's stockholder list and other books and records upon making a written demand setting forth a 'proper purpose' for the request." It defines a "proper purpose" as one "reasonably related to such person's interest as a stockholder." If, after the corporation denies shareholder access to its records, suit may be commenced in Chancery Court.

9. Nicholas Confessore, "Qualcomm Reveals Its Donations to Tax-Exempt Groups," *N.Y. Times*, Feb. 22, 2013, available at http://cityroom.blogs.nytimes.com/2013/02/22/qualcomm-agrees-to-reveal-donations-to-tax-exempt-groups/?emc=eta1. The list of contributions may be found on Qualcomm's website: http://investor.qualcomm.com/governance.cfm.

10. H.R. 5175 (111th Cong). A second attempt at a similar measure was made in March 2012. See H.R. 4010 "Democracy is Strengthened by Casting Light on Spending in Elections Act of 2012" (112th Cong.).

11. For example, Senators Ron Wyden (D-Oregon) and Lisa Murkowski (R-Alaska) collaborated on a new disclosure proposal that aims to close anonymous spending loopholes.

12. The SEC is generally entitled to promulgate regulations pursuant to the authority granted by Congress under the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Sarbanes-Oxley Act of 2002, and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

13. See Anna Palmer and Zachary Warmbrodt, "Campaign Finance Fight Lands at the SEC's Door," POLITICO, Jan. 8, 2013, available at http://www.politico.com/story/2013/01/campaign-finance-fight-lands-at-the-secs-door-85917.html.

14. Sue Reisinger, "Congress and SEC Mulling New Rules for Corporate Campaign Donations," Law.com, Jan. 10, 2013, available at http://www.law.com/corporatecounsel/PubArticleCC.jsp?id=1202583774773&Congress_and_SEC_Mulling_New_Rules_for_Corporate_Campaign_Donations&slreturn=20130023113950.

15. 17 C.F.R. Part 275 (2010). See also SEC Release IA-3043.

16. SEC Release IA-3043, at 6.

17. See The Gift Tax and Contributions to Section 501(c)(4) Organizations: Less than Meets the Eye, Caplin and Drysdale Alert (June 14, 2011), available at http://www.capdale.com/alert-the-gift-tax-and-contributions-to-section-501c4-organizations-less-than-meets-the-eye. Under Internal Revenue Code §2522, contributions to 501(c)(3) organizations are exempt from the gift tax, but no such exception is provided for 501(c)(4) organizations.

18. Stephanie Strom, "IRS Drops Audits of Political Donors," *New York Times* (July 7, 2011).

19. See "Crossroads GPS Does Not Deserve Tax-Exempt Status, Watchdog Groups Say," Tax Notes Today, 2013 TNT 189-16 (Jan. 2, 2013).

20. See Internal Revenue Code §501(c)(4)(A). Although 501(c)(4) organizations may intervene in political campaigns, the organization's activities must be "primarily" in furtherance of social welfare. Internal Revenue Manual §4.76.14.4.2.

21. See Internal Revenue Code §11(a) (tax imposed on corporations); Internal Revenue Code §501(a) (exempting organizations described by Internal Revenue Code §501(c) from tax under Internal Revenue Code §11(a)). An organization structured as a trust that is not exempt from tax would be subject to the applicable taxes on trusts under Internal Revenue Code §1(e).

22. IRS Exempt Organizations FY 2012 Annual Report & FY 2013 Workplan, available at http://www.irs.gov/pub/irs-tege/FY2012_EO_AnnualRpt_2013_Work_Plan.pdf.

23. Because formal exemption filings and returns of exempt organizations are public information, avoiding a formal exemption filing and waiting to file a return until after the election cycle is concluded prevents public disclosure of any useful information about the organization until long after the organization has exerted its influence on the political process. See Internal Revenue Code §6104.

24. Although Treas. Reg. 1.501(a)-1(3) states that an organization claiming exemption under 501(c) "shall file the form of application prescribed by the Commissioner," the specific addition of Internal Revenue Code §508, which specifically requires 501(c)(3) organizations to file in order to gain exemptions, has been interpreted to mean that other 501(c) organizations are not explicitly required to file for exemption in order to be treated as tax-exempt. See also Nancy Ortmeyer Kuhn, "Secretive No More: Nonprofits Must Disclose Donors," Tax Notes Today, 2012 TNT 168-6 (Aug. 29, 2012).