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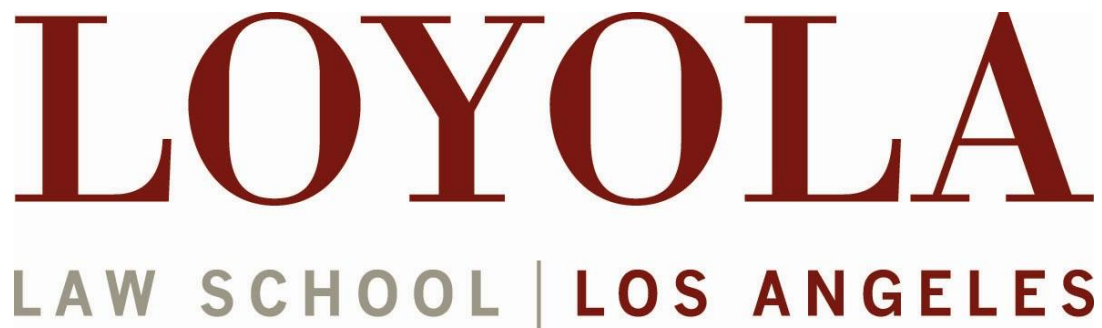
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Legal Defense Funds as Political Organizations

Professor Ellen P. Aprill

Legal Defense Funds as Political Organizations

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This report lays out the advantages of, and difficulties with, registering a congressional legal defense fund as a section 527 organization. It begins by offering as background a summary of the congressional and executive branch rules that apply to these funds, the Federal Election Commission's position on them, and a brief description of the best-known legal defense funds — the two established by President Clinton.

The report considers whether contributions to funds that do not register as section 527 organizations are income to the official and, if so, whether there are matching deductions. The report examines whether contributors to the legal defense funds could have gift tax liability. It concludes the tax section by examining whether the trust would be considered a grantor trust.

The report then explains the use of a section 527 organization for such a fund and describes how that use can avoid both income and gift tax liability that a legal defense fund might otherwise generate. The report also discusses how a legal defense fund becomes a section 527 organization and describes two funds established by state officeholders that operated as section 527 organizations. Finally, the report recommends that the House and Senate rules regarding legal expense funds be amended to explicitly recognize section 527 legal defense funds.

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Last summer, Sen. John Ensign, R-Nev., then the subject of legal inquiries by both the Senate Select Committee on Ethics and the Justice Department,¹ established a legal expense fund trust in accordance with Senate rules. Many others have done the same. Senators facing ethics and criminal proceedings who have set up legal expense fund trusts in recent years include Larry Craig, David Vitter, R-La., Ted Stevens, and Roland Burris. The most famous legal defense funds, of course, are those established not for any senator, but the two established for President Clinton.² Unlike any of those legal defense trusts, however, the Ensign Legal Expense Trust Fund³ registered as a section 527 political organization. According to *Roll Call*, campaign finance experts saw this use of section 527 as "unusual and perhaps unprecedented."⁴ It is not in fact unprecedented for a politician to register a legal defense fund (LDF) as a section 527 organization, but it is unusual and perhaps unique for a member of Congress to do so.

¹The DOJ has since decided not to pursue charges against Ensign. See Eric Lichtblau and Eric Lipton, "Prosecutors Won't Charge Ensign," *The New York Times*, Dec. 1, 2010, available at <http://www.nytimes.com/2010/12/02/us/politics/02ensign.html>.

²I will use both the terms "legal expense fund" and "legal defense fund." For purposes of this report, the terms are interchangeable. In other contexts, such as a fund to challenge state voting procedures, the fund could not accurately be called a legal defense fund.

³On file with author.

⁴Jennifer Yachnin, "Ensign Takes Unusual Step in Registering Defense Fund," *Roll Call*, Aug. 3, 2010, available at <http://www.rollcall.com/news/48964-1.html>.

The motive for registering a legal expense fund trust as a section 527 organization is to avoid what might otherwise be enormous tax liabilities for the politician establishing the fund. Under the applicable tax authorities, expenditures from amounts contributed to those trusts or from any earnings on those contributions are likely to be gross income to the politician, because they benefit the public official and the need for them arises out of the politician's official duties. They are unlikely to be gifts. At the same time, however, the 2 percent floor of section 67 and the alternative minimum tax limit the extent to which the official can take business deductions for expenditures from the fund. As a result, a politician who establishes and benefits from a legal expense fund can face large income tax liabilities. Moreover, if these legal expense trusts are properly characterized as grantor trusts, any income earned by the funds will also be taxable to the public official; if not, the trust itself will have reporting obligations. Gift tax issues for contributors arise as well.

In contrast, if a legal expense fund can and does register as a section 527 organization, the public official will not have any tax liability from contributions to or expenditures from the fund. To the extent that contributions to an organization that qualifies as a section 527 organization and expenditures from it constitute "exempt function income," they are not subject to income tax. Also, contributions to a section 527 organization are explicitly free of gift tax under the code. A section 527 organization, however, would be subject to tax on any investment income.

Exempt function income of section 527 organizations was long limited to contributions and expenditures related to the selection of candidates. In 1988, however, Congress amended the definition of exempt function under section 527 to include expenditures "which, if incurred by the individual [holding a public office], would be allowable as a deduction under section 162(a)." It is that 1988 amendment broadening the definition of exempt function that makes it possible to register a legal expense fund as a section 527 organization.

Given the amendment of section 527 in 1988 to include the making of section 162(a) expenditures within the definition of exempt function, the use of section 527 legal defense funds for legal proceedings relating to official duties while in office falls comfortably within both the language and intent of the statute. Failure by other members of Congress to register their legal defense funds as section 527 organizations is thus surprising. Members may have hesitated to do so because neither the House nor the Senate rules explicitly recognize the ability to register these legal defense funds under section

527. This report explains why both sets of rules should be amended to acknowledge that legal expense fund trusts can qualify under section 527.

I. Background

A. Congressional Rules

Legal expense funds have become so commonplace that both the House and the Senate have established specific rules for them.⁵ Both sets of rules refer to the need for guidance in light of otherwise applicable rules limiting acceptance of gifts. The Senate regulations also note that Senate rules prohibiting "unofficial office accounts" for "the purpose of defraying allowable but otherwise unreimbursed expenses incurred in connection with official duties" had raised doubt about the permissibility of legal expense funds. Under both House and Senate rules for legal expense funds, the fund can be used to pay only for investigative, civil, criminal, or other legal proceedings relating to an officeholder's election to office, official duties while in office, and administrative or fundraising expenses of the fund, including any tax liabilities. The funds cannot be established for purely personal matters, such as tax planning or divorce. Both houses of Congress require approval of the fund by the appropriate ethics committee before receiving any contributions. The member must appoint a trustee to manage the account — that is, the fund must be a trust. The Senate provides members a

⁵House Committee on Standards of Official Conduct, "Memorandum to All Members, Officers and Employees: Legal Expense Fund Regulations" (June 10, 1996), Appendix to *House Ethics Manual* at 394, available at http://ethics.house.gov/Media/PDF/2008_House_Ethics_Manual.pdf; Senate Select Committee on Ethics, "Regulations of Trust Funds to Defray Legal Expenses Incurred by Member, Officers, and Employees of the United States" (amended Aug. 10, 1988), *Senate Ethics Manual*, Appendix I, available at <http://ethics.senate.gov/downloads/pdffiles/manual.pdf>. The Senate regulations for legal defense funds date back to 1980; House regulations date back to 1993. See Kathleen Clark, "Paying the Price for Heightened Ethics Scrutiny: Legal Defense Funds and Other Ways That Government Official Pays Their Lawyers," 50 *Stan. L. Rev.* 65, 98 n.4 (1997). The recent investigation of former Ways and Means Committee Chair Charles B. Rangel, D-N.Y., regarding House ethics violations underscores congressional acceptance of these funds. When Rangel walked out of the hearing before the House Ethics Committee, which was investigating charges that he violated congressional ethics rules on fundraising, he justified his action by stating that he could no longer afford a lawyer to defend him. "But as the committee chairwoman, Zoe Lofgren, pointed out, the committee has repeatedly advised Mr. Rangel since 2008 that he could set up a defense fund to raise the money, which he has not done." Editorial, "Mr. Rangel Walks Out," *The New York Times*, Nov. 16, 2010, at A-30.

sample form, "Legal Expense Trust Fund,"⁶ to which the Ensign fund conforms.⁷ It names the member as the "Grantor" and requires that the grantor assign \$10 to the trustee.

Both sets of rules limit contributions from those other than the member and the member's family. The House limits contributions to \$5,000 per year from any single source and prohibits contributions from registered lobbyists and foreign nationals. The Senate limits contributions to \$10,000 and prohibits contributions from lobbyists, foreign nationals, corporations, unions, and any member's principal campaign committee. Quarterly reports on expenditures and contributions, including the full name and street address of donors and recipients of expenditures, must be filed with the Legislative Resource Center in the House or the Secretary of the Senate. The House requires disclosure of all contributions and expenditures of \$250 or more and all contributions from corporations and unions, while the Senate has a much lower threshold of only \$25 per year for those disclosures. The Senate requires any excess funds remaining at termination of the fund to be donated to charity or returned to contributors. The House requires that excess funds be returned to contributors.

B. Election Law

Election law allows defense funds such as the one established by Ensign. The 1996 House memorandum stating that the Committee on Standards of Official Conduct permits members to use campaign funds to defend legal action arising out of "their campaign, election, or performance of their official duties" nonetheless recommends that any member contemplating that use of campaign funds first contact the Federal Election Commission. For legal expense funds related to performance of official duties, a number of FEC advisory opinions permit campaign funds to be transferred into those funds.⁸ These opinions reason that a current or former federal candidate may use campaign funds "for ordinary and necessary expense incurred in connection with duties of the individual as a holder of federal office"⁹ and that the legal fees arise out of alleged violations of rules, laws, or regulations governing the performance or discharge of official duties. As a result, for election law purposes the

expenses are ordinary and necessary expenses incurred in connection with official duties. Further, the opinions give assurance that the use of these funds in connection with legal proceedings involving allegations concerning an individual's duties as a federal officeholder would not constitute personal use. They explain that those fees and expenses would not exist irrespective of the individual's duty as a federal officeholder. Neither are contributions from a fund deemed campaign contributions subject to FEC limits on campaign contributions, because they are not funded "for the purpose of influencing any election under federal law."¹⁰

C. Executive Branch

Rules applicable to executive branch employees also permit legal defense funds. For executive branch officeholders, available general guidance consists of a 1993 informal advisory letter from the Office of Government Ethics (OGE).¹¹ That letter involved a legal defense fund established in connection with an administrative proceeding concerning charges brought against an employee by the employee's department. It overturned a 1985 letter to conclude that a legal defense fund established within specified guidelines would not violate 18 U.S.C. section 209, which forbids any executive branch employee of the U.S. government from receiving any salary supplements from anyone outside the U.S. government.

Relying on the interpretation of the salary supplement statute in *Crandon v. United States*,¹² the 1993 letter said that the policies underlying the statute would not be violated in connection with a fund "where there is donor anonymity, where the fund would be administered by persons having connection with the employee's official duties and no discretion about whether to pay, where the employee would not have possession of the money, and where no funds would be accepted from prohibited sources [that is, persons who have a vested interest in official actions of the officeholder or the officeholder's agency], nor from subordinates."

⁶Sample Senate trust form, dated Sept. 2008, available at http://ethics.senate.gov/downloads/pdffiles/Legal%20Expense%20Trust%20Fund_Sample%20Form.pdf (Senate model).

⁷Copy on file with author.

⁸See Advisory Opinions 2006-35 (Kolbe), 2005-11 (Cunningham), 1998-01 (Hilliard), 1997-12 (Costello), 1996-24 (Cooley), and 1995023 (Shays).

⁹2 U.S.C. section 439(a)(2); 11 C.F.R. section 113.2.

¹⁰2 U.S.C. section 431(8). This report is limited to the treatment of legal defense funds established to defend members of Congress in ethics or criminal proceedings and investigations arising from their conduct in office. The treatment of legal defense funds set up for legal proceedings in connection with recounts or challenges to a state's electoral system to a federal election is less certain. Compare Advisory Opinion 2006-24 with Advisory Opinion 2003-15.

¹¹OGE, Letter to an Alternate Designated Agency Ethics Official (Aug. 30, 1993), available at http://www.usoge.gov/ethics_guidance/opinions/advop_files/1993/93x21.pdf. For a critique of its analysis, see Clark, *supra* note 5, at 91-94.

¹²494 U.S. 152 (1990).

The letter stressed the importance of donor anonymity to prevent improper influence — a position in sharp contrast to the required disclosure under the House and Senate rules.¹³ It cautioned that, because the donations are in the nature of gifts rather than payment for services, employees receiving benefits under a legal defense fund would have to comply with applicable regulations regarding the receipt of outside gifts. Moreover, no excess in the fund is to be transferred to or accepted by the employee.

D. Clinton Legal Defense Funds

Clinton established two different legal defense funds to help pay for his legal expenses and those of his wife, Hillary, in connection with charges of lying under oath, Whitewater, the Paula Jones sexual harassment lawsuit, and the Monica Lewinsky controversy. The first fund, established by the Clintons in 1994 on their own behalf, was called the Presidential Legal Expense Fund. It was established with \$2,000 from the Clintons.¹⁴

The president and the vice president are not subject to federal gift restrictions applicable to other executive branch employees, whether as to source or amount,¹⁵ and this exemption eased establishment of the Presidential Legal Expense Fund. Clinton and his advisers, however, established an annual limit of \$1,000 for the fund, an amount based on the then-applicable federal campaign contribution limits.¹⁶ Initially, the Presidential Legal Expense Fund accepted donations from lobbyists, but after criticism — particularly from Republicans who pointed out that the president in his State of the Union address had called on members of Congress to stop taking gifts from lobbyists — the fund stopped accepting gifts from registered lobbyists. “Contributions to the Clinton LDF seem to have dropped off considerably after it stopped accepting contributions from lobbyists.”¹⁷

¹³The OGE has apparently abandoned the position that “donor anonymity is an essential characteristic of a legal defense fund.” Clark, *supra* note 5, at 93, quoting letter of Marilyn Glynn, general counsel of the OGE, to Kathleen Clark.

¹⁴Lee A. Sheppard, “The Tax Treatment of the Clintons’ Legal Defense Fund,” *Tax Notes*, July 4, 1994, p. 12, 94 TNT 130-4.

¹⁵5 C.F.R. section 2635.204(j).

¹⁶Clark, *supra* note 5, at 89.

¹⁷*Id.* The trust’s executive director and White House counsel Abner Mikva was quoted as saying, “If you really set up a fund which will see to it that the people who are likely to give can’t give, what’s the point of having the fund?” Clark, *supra* note 5, at 89 n.117, citing Ruth Marcus, “Clinton Legal Fund Bars Donations by Lobbyists: Change in Policy Follows GOP Criticism,” *The Washington Post*, Jan. 26, 1995, at A-1. The fund received \$608,080 in contributions from June 28 to Dec. 31, 1994, a period during which lobbyists could contribute, but only

(Footnote continued in next column.)

The OGE significantly shaped the Presidential Legal Expense Fund. In contrast to the guidelines set out in the 1993 advisory letter, the fund disclosed the donors’ names and contribution amounts biannually, a decision that followed a letter of approval from the OGE acknowledging the value of public disclosure for the fund.¹⁸ The OGE also took the position (apparently unanticipated by presidential advisers) that although the president was not subject to rules limiting the acceptance of gifts, he and his agents — such as the fund itself and its officials — were subject to laws forbidding executive branch officials from soliciting gifts, because he and his wife were the grantors of the trust.¹⁹ Eventually, money ceased to come in,²⁰ and the trust was terminated in December 1997.

Supporters of the president and Mrs. Clinton, with their authorization, created a new legal defense fund in 1998, the Clinton Legal Expense Trust.²¹ Rather than being established by the Clintons, the new fund was established by some of his supporters. The OGE wrote the lawyers for the new trust that such a fund would not be considered an agent of the president and thus could solicit donations. The fund also increased the maximum gift to \$10,000 per year, the amount established under Senate rules. To ensure that contributions would be a gift of a present interest and eligible for the annual gift tax exclusion, the trust explicitly gave *Crummey* demand powers to the Clintons by providing that they would have a period of 30 days during which they could appoint the funds to themselves.²² This second trust considered accepting contributions from lobbying groups, political action committees,

\$258,449 from Jan. 1 to June 30, 1995, after the lobbyist ban went into effect. Clark, *supra* note 5, at 89 n.120.

¹⁸Public Citizen, “Legal Defense Fund Rules for Officials of the Congressional and Executive Branches” (July 28, 2005), available at <http://www.cleanupwashington.org/documents/LegalFund.pdf>.

¹⁹Ruth Marcus, “Clinton’s Legal Defense Fund Considers Independent Effort to Boost Collections,” *The Washington Post*, Dec. 18, 1994, at A-22. The OGE’s characterization of these funds, of course, does not influence their treatment for federal tax purposes.

²⁰See Wolf Blitzer, “New Clinton Legal Defense Fund Created,” All Politics/CNN (Feb. 18, 1998), available at <http://www.cgi.cnn.com/ALLPOLITICS/1998/02/18/defense.fund/>. The fund also had to return some \$600,000 raised by the indicted Clinton fundraiser Charlie Trie.

²¹*Id.*; John F. Harris, “Clinton Approves New Legal Fund,” *The Washington Post*, Feb. 19, 1988, at A-12.

²²See Sheppard, “Clinton Defense Fund II: What Was the Bill From the Tax Lawyers?” *Tax Notes*, Mar. 9, 1998, p. 1226, Doc 98-8608, or 98 TNT 46-3. The Clintons, however, signed a letter stating that they would not exercise this demand power.

unions, and corporations but decided to limit donations to individuals. As of March 14, 2001, it had collected \$8.7 million and paid \$7.4 million.²³

II. Tax Issues

A. Introduction

Both the House and Senate rules require that a legal expense fund be established as a trust. Clinton established both legal defense funds as trusts, with the OGE making important distinctions between the fund established by the Clintons and the fund established on their behalf by others. A trust clearly seems to be the most common structure for legal defense funds of prominent officeholders.²⁴ Most often, these trusts are established by officeholders who transfer the initial funds to the trust,²⁵ solicit contributions to it, and receive its benefits by having the trust pay legal bills in connection with charges against them. As many authors have considered in connection with the Clinton legal defense fund trusts,²⁶ these funds raise questions regarding whether the government official must include contributions to the fund in income and, if so, the extent to which deductions are available for amounts expended.

²³John R. Dorocak, "The Clintons' Legal Defense Fund: Income From Payment of Legal Expenses by Another and the Deductibility of Such Expenses," 104 W. Va. L. Rev. 1, n.2 (2001), also available at Doc 2003-14658 or 2003 TNT 122-22. Dorocak took these numbers from the fund's website, which is no longer available.

²⁴See Beryl M. Abbin, *Income Taxation of Fiduciaries and Beneficiaries*, para. 1407.3.14 (assuming without analysis that legal defense funds are a form of grantor trust).

²⁵The Senate model legal expense fund trust calls for the officeholder to transfer at least \$10 on creation of the trust. Clinton's first legal defense trust was funded with \$2,000 from the Clintons. See Sheppard, *supra* note 14.

²⁶See Dorocak, *supra* note 23; Kip Dellinger, "Tax the Clinton Legal Defense Funds? Don't Hold Your Breath," *Tax Notes*, Aug. 18, 2003, p. 967, Doc 2003-18841, or 2003 TNT 160-30; Dellinger, "The Clinton Legal Defense Fund: Better Than a Corporate Tax Shelter," *Tax Notes*, May 29, 2000, p. 1279, Doc 2000-15282, or 2000 TNT 104-103; Sheppard, "A Look at the Clinton and Gore Tax Returns," *Tax Notes*, Apr. 24, 2000, p. 472, Doc 2000-11743, or 2000 TNT 79-3; Sheppard, *supra* note 22; Dellinger, "The Clinton Legal Defense Funds: Tax Return Compliance Issues," *Tax Notes*, Mar. 30, 1998, p. 1719, Doc 98-10684, or 98 TNT 60-48; Dellinger, "The Income Tax Aspects of the Clintons' 'New' Legal Defense Fund," *Tax Notes*, Mar. 9, 1998, p. 1325, Doc 98-8504, or 98 TNT 45-56; Dellinger, "The Clinton Legal Defense Fund: The Tax Issue Remains Unanswered," *Tax Notes*, Aug. 18, 1997, p. 985, Doc 97-23777, or 97 TNT 159-44; Dellinger, "The Clintons' Legal Defense Fund: Don't Ignore the Tax Issue," *Tax Notes*, June 26, 1995, p. 1821, 95 TNT 126-69; Sheppard, "The Tax Treatment of Clinton's Legal Defense Fund, Continued," *Tax Notes*, May 22, 1995, p. 1008, 95 TNT 99-6; Sheppard, *supra* note 14.

B. Income

A key issue is whether contributions to a legal expense fund trust or its expenditures for litigation expenses can be excluded from the official's income as gifts under section 102. As always, the test for whether an amount is given as a gift excludible from income is that of *Commissioner v. Duberstein*,²⁷ which asks whether the donor acted out of "detached and disinterested generosity," based "on the fact-finding tribunal's experience with the main-springs of human contact to the totality of the facts of each case." In *Duberstein*, because the taxpayer received a new Cadillac from a business associate to whom he had provided names of potential customers, "it was at bottom a recompense for Duberstein's past services, or an inducement for him to be of further service in the future,"²⁸ and not a gift excluded from income.

Characterization of a transfer as a gift is a question of fact. In *United States v. Pisani*,²⁹ the Second Circuit reversed a conviction on eight income tax counts on the grounds that the judge erroneously instructed jurors that campaign funds diverted to personal use could not be gifts, rather than submitting that issue of fact to the jury.

Revenue rulings and other tax authorities set a high bar for finding a gift in connection with contributions either to legal defense funds or to politicians. In Rev. Rul. 60-14,³⁰ sums contributed to a committee organized to raise funds for a taxpayer's legal defense were income to the taxpayer and not gifts. The taxpayer, an official of an organization, was involved in litigation of a personal nature, but the litigation focused national attention on the organization. Although money contributed would go to pay the individual's litigation costs, the officials of the organization formed the legal defense committee "for the professed purpose of counteracting unfavorable publicity" and raised funds from members of the organization. The committee made regular reports to the organization's executive board. Excess funds were turned over to the organization. On those facts, the funds expended by the committee were not gifts to the taxpayer but constituted gross income to him. The committee's aim of benefiting the organization indicated lack of donative intent.

Both subscription fees and solicited contributions received by a congressman solely to defray the costs of a newsletter, reports, and questionnaires sent to constituents were includable in the congressman's

²⁷363 U.S. 278 (1960).

²⁸*Id.* at 292.

²⁹773 F.2d 397 (2d Cir. 1985).

³⁰1960 C.B. 16.

gross income, according to Rev. Rul. 73-356.³¹ The subscription fees were payment for the publications, and the solicited funds were made to assure continued publication. Thus, none of the monies were a gift under section 102 or *Duberstein*, because the payments proceeded “primarily from the incentive of anticipated benefits of an economic nature.”

Rev. Rul. 75-146³² reached a similar conclusion. It involved funds solicited by a U.S. lawmaker to support an intern program. The ruling concluded that contributions were not made out of detached and disinterested generosity, because donors contributed to the intern fund “with the intention of obtaining a more efficient public servant.” Further, that the lawmaker used the funds “to conduct his public duties more efficiently” meant that the amounts received by the intern fund were includable in the lawmaker’s gross income in the year they were received by the fund.

That contributions are made to a trust does not shield the officeholder from having to include amounts in income. In Rev. Rul. 76-276,³³ a member of Congress established a trust with independent trustees for contributions to be used for travel expenses related to the taxpayer’s service as a member of Congress incurred by the member and the member’s staff in excess of the congressional allowance for those expenses. The ruling concluded that “the contributions enable the Member of Congress to become more accessible to constituents which, in turn, provides constituents with the opportunity of obtaining more effective representation in Congress.” Thus, the contributions were income and not gifts under *Duberstein*. The ruling explains that the member benefited from the trust and could control distributions from it by determining the extent of travel. The ruling reaches this conclusion even though at least some of the travel expenses were allowed only if, in the opinion of the trustees, the travel allowed the taxpayer to better serve the needs of the taxpayer’s constituents.

Rev. Rul. 76-276 relied on *Mount Vernon Gardens Inc. v. Commissioner*,³⁴ in which the trust agreement provided that on written instructions from the taxpayer, the independent trustee was to expend the funds from those the taxpayer had deposited in trust for specified limited purposes that would benefit the taxpayer. The ruling describes no similar provision in the trust agreement established by the

member of Congress. Nonetheless, the ruling concludes that the same principle applied to the member’s travel funds.

The conclusion is likely to be the same as that in Rev. Rul. 76-276 in the case of a legal expense fund trust. *Old Colony Trust Co. v. Commissioner*,³⁵ in which an employer’s payment of federal income taxes on behalf of its employee constituted income to the employee, supports this conclusion. As the *Old Colony* Court explained, the discharge by a third person of a taxpayer’s obligations is equivalent to receipt of the funds by the taxpayer.³⁶ The member who establishes a legal expense fund trust following the Senate model, however, has somewhat less control over the costs of legal counsel than did the member in Rev. Rul. 76-276 regarding travel expenses. Under the Senate model, although the member is named the grantor and beneficiary of the trust,³⁷ “he shall exercise absolutely no control over the Trust property and shall receive no tangible or intangible benefit from the Trust other than such benefit that is incident to or may have arisen from past legal representation.”³⁸ At the same time, the trustee has the duty to “enter into any legal agreement with legal counsel selected by the Grantors, including agreement relating to compensation.”³⁹ Thus, although the member does not personally enter the legal agreements, he selects legal counsel and benefits from the legal agreements.

When Clinton’s first legal defense fund was established, M. Bernard Aidinoff of Sullivan & Cromwell LLP advised that contributions to the fund would be gifts, although not, apparently, in a written opinion. According to reports, he took that position in part on the grounds that because the president’s legal duties arose out of events that occurred before he took office, the expenses of defending the claims could not be characterized as helping him carry out his official duties and thus the amounts received did not satisfy one of the criteria the IRS has adopted in treating amounts received by politicians as income.⁴⁰ The Clintons’ second trust fund, however, also involved defense in connection with the Lewinsky controversy, and those events took place while the president was in

³¹1973-2 C.B. 31.

³²1975-1 C.B. 23.

³³1976-2 C.B. 14.

³⁴298 F.2d 712 (6th Cir. 1962).

³⁵279 U.S. 716 (1929).

³⁶See Dorocak, *supra* note 23.

³⁷Senate model, *supra* note 6, Recital A; Beneficiary, art. 3.

³⁸*Id.* at Beneficiary, art. 3.

³⁹*Id.* at Duties of Trustees, art. 6A.

⁴⁰Sheppard, “The Tax Treatment of the Clintons’ Legal Defense Fund,” *supra* note 14. See also Testimony of Lloyd N. Cutler, Special Counsel to the President before the Hearing of the House Banking Committee re Whitewater (July 26, 1994), available in LEXIS Legislation and Politics, Congressional Hearing (stating that Aidinoff believes there is no tax liability as the result of funds entering the legal defense trust).

office. Moreover, as others have noted, to the extent that helping Clinton with attorney fees enabled him to function and restored his reputation as president, that aid could well be characterized as helping him carry out his official duty and thus as lacking donative intent. The very name of the first trust, the Presidential Legal Expense Fund, makes a connection to his office. That contributions to the first fund dropped precipitously when it stopped accepting donations from lobbyists also suggests that, in many cases, generous contributions were not made out of detached and disinterested generosity.

Whatever the special circumstances of the Clinton legal defense funds, the House and Senate rules permit legal defense trusts only for proceedings relating to an officeholder's election to office or official duties while in office.⁴¹ That requirement makes it unlikely that the IRS would characterize monies donated to or expended from these legal expense fund trusts as gifts to the public officials establishing them. Moreover, data show that the more powerful the member, the greater the contributions to a legal defense fund.⁴² Those facts further suggest that many of the monies given to these funds are not given as gifts out of detached and disinterested generosity. Gifts from unions, corporations, and political action committees, as the House rules permit, may also be more difficult to characterize as gifts for income tax purposes.

In short, establishing that contributions to legal expense fund trusts are gifts for income tax purposes is difficult at best. Congressional rules that permit legal expense fund trusts, and applicable tax authorizes, make it likely that in all but the most unusual cases these amounts would be deemed income to the member of Congress and should be reported as such.

C. Deductions

Even if contributions to the legal expense fund trust are treated as gross income to an embroiled politician, the ultimate tax consequences will not be onerous if the politician can also take a tax deduction for amounts expended for legal costs.⁴³ Rev. Rul. 73-356, Rev. Rul. 75-146, and Rev. Rul. 76-276,

all cited above, also conclude that amounts that must be included as gross income are still deductible under section 162(a) as ordinary and necessary business expenses. Rev. Rul. 73-356 and Rev. Rul. 76-276 also note that section 7701(a)(26) provides that the term "trade or business" includes the performance of the functions of a public office.

Other revenue rulings make this point as well. Rev. Rul. 71-470⁴⁴ concludes that expenses incurred by an elected public official against a recall from public office are deductible as ordinary and necessary business expenses. Another ruling, Rev. Rul. 74-394,⁴⁵ finds that legal expenses paid by a state judge in connection with obtaining a dismissal of misconduct charges brought against him by a state commission are deductible expenses under section 162. Rev. Rul. 74-394 looked to *Commissioner v. Tellier*,⁴⁶ in which the Supreme Court held that legal expenses incurred by a taxpayer in the unsuccessful defense of a business-related criminal prosecution were deductible under section 162(a). As the ruling explained, the Supreme Court in *Tellier* had relied on *United States v. Gilmore*,⁴⁷ which held that the origin and character of a claim and not its potential consequences control whether an expense is connected with a taxpayer's trade or business under section 162. In the ruling, because the charges against the taxpayer arose out of the allegation that he had used the prestige of his office to advance private commercial interests, the charges had their origin in the conduct of his duties as a judge.

Again, because the House and Senate rules limit the situations in which a legal expense fund is allowed for proceedings related to the member's office, expenses paid by those funds should satisfy the *Gilmore* origin of the claim test. Rev. Rul. 74-394, however, also reminds us that although performance of services as an employee is considered the conduct of a trade or business, expenses attributable to the performance of a trade or business as an employee are deductible only if the employee itemizes expenses.

Moreover, under current law, unreimbursed employee expenses are deductible only as miscellaneous itemized deductions under section 67(b). Section 67(b) permits miscellaneous itemized deductions only to the extent they exceed 2 percent of the taxpayer's adjusted gross income. Also, under section 56(b)(1)(A), no miscellaneous itemized deductions are allowed for purposes of the AMT.

⁴¹Similarly, the OGE advisory letter also involved an investigation arising out of charges brought by an employee's department.

⁴²See Clark, *supra* note 5, at 103-104.

⁴³Even if contributions were deemed a gift to the officeholders, section 162(a) could permit deductions, although it is the mismatch between income and deductions that makes traditional legal defense fund trusts so problematic. Moreover, to the extent that deductions are allowed, there may well be a timing mismatch for at least some contributions, with income in year 1 and no deductions until year 2, when amounts are paid to legal counsel.

⁴⁴1971-2 C.B. 121.

⁴⁵1974-2 C.B. 40.

⁴⁶383 U.S. 687 (1966).

⁴⁷372 U.S. 39 (1963).

While section 62(a)(20) permits above-the-line deductions for the costs of attorney fees and court costs in connection with some kinds of suits concerning employment,⁴⁸ expenses are deductible only to the extent of judgment or settlements. Thus, this section would not apply to permit deduction in the case of legal expense funds, because the officeholder is a defendant. Deductions for expenditures from legal defense fund trusts will be severely limited, if allowed at all.

In brief, while the tax law requires House and Senate members to include in income amounts contributed to or expended from legal defense trust funds, it does not permit them to take matching deductions. Because amounts expended are unreimbursed employee expenses, members will be able to take only limited deductions under the regular tax and none under the AMT for the amounts expended from those trusts for the legal costs they were established to cover. Members will be left with a substantial tax liability.⁴⁹

Whether members of Congress have reported amounts of gross income and deductions in accordance with these rules is, of course, unknown. We know that Clinton did not.⁵⁰

D. Gift Tax

The standards for whether a transfer is a gift under section 102 for income tax purposes, of course, are not the same as those for judging a gift under the gift tax. Section 2512(b) provides that when property is transferred “for less than full and adequate consideration in money or money’s worth,” the amount by which the value of the property exceeds the value of consideration will be deemed a gift. Amounts within the annual exclusion of section 2503(b), currently \$13,000, are deemed not to be taxable gifts and thus do not reduce an individual’s unified gift tax credit or generate out-of-pocket gift tax liability if they are gifts of a present interest.

Both the House and Senate rules set an individual’s maximum contribution to a legal expense trust at amounts below the current annual exclusion. Executive branch officeholders are subject to strict limitations regarding the acceptance of gifts, and these limitations are not waived for legal defense funds, as the 1993 advisory opinion explains. In general, executive branch employees, with the ex-

ception of the president and vice president, can receive a single gift worth up to \$20 on a single occasion but not more than \$50 worth of gifts from a single source per year.⁵¹ Thus, if contributions to these legal expense trusts satisfy the rules regarding eligibility for the annual exclusion, they will not be taxable gifts.

However, as noted in connection with discussion of the second Clinton defense fund, a transfer must be a transfer of a present interest in property to be eligible for the annual exclusion under the gift tax. To satisfy the present interest requirement, the legal expense trust fund can include provisions, such as demand power — the right by the official to appoint contributions to himself, as seen in so-called *Crummey* trusts — to satisfy the present interest requirement. As Lee A. Sheppard has written, depending on the particular provisions of the trust instrument, donors to a legal expense fund trust might also be able to rely on the fact that the politician beneficiary can demand funds as needed to cover legal expenses to satisfy the present interest requirement.⁵² The Senate model trust, however, does not bestow any kind of *Crummey* power on the beneficiary member of Congress. Moreover, as noted above, the Senate model has the legal expense fund trust contract directly with the lawyers. Although funds expended are for the benefit of the beneficiary, he does not control the timing of payment. Funds are not distributed to the beneficiary on his demand in order for him to pay legal costs.

The Senate model, however, does give the member the right to terminate the legal expense fund trust: “The Trust established by this Agreement may be terminated at any time by the Trustee upon the director of the Grantor.”⁵³ Under the Senate model, on termination, any remaining funds must be donated and distributed to organizations exempt under section 501(c)(3) or returned to contributors to the trust on a pro rata basis.⁵⁴ The question thus becomes whether the member’s ability to terminate the trust at any time and choose section 501(c)(3) organizations to which the funds will be distributed could be deemed a power to appoint the property to himself. The very purpose of the termination provision is to prevent the member from personally benefiting from any monies in the legal expense fund, and it seems unlikely that the limited termination power would be sufficient to qualify contributions to the trusts as a present interest.

⁴⁸See section 62(e).

⁴⁹Even if, as the Senate rules explicitly provide, amounts contributed to the fund may be used to cover tax liabilities, the limited deductibility of these expenses will increase considerably the dollars in the trust needed to cover costs, and any of those dollars further increase taxable income.

⁵⁰See Dorocak, *supra* note 23, at 5.

⁵¹See C.F.R. section 2635.201-205.

⁵²See Sheppard, “Clinton Defense Fund II,” *supra* note 22.

⁵³Senate model, *supra* note 6, art. 12.

⁵⁴*Id.*, art. 13.

Thus, gift tax issues indeed arise for a legal expense fund trust established following the Senate model. That is, the gift tax could well apply to these contributions, and if so, even individuals making contributions will use some of their unified credit or pay gift tax, as applicable.

Contributors might argue, however, that their contributions are protected from the gift tax based on two cases in which the IRS lost the argument that contributions to political campaigns were subject to the gift tax. In the first case, *Stern v. United States*,⁵⁵ Edith Stern attached a statement to a gift tax return explaining that her transfers to a group supporting a reform slate of candidates were made to protect her property and personal interests by promoting efficiency in government, and that the funds were used on her behalf for handbills, posters, television and radio publicity, and other campaign expenses. The Fifth Circuit concluded that those transfers were made in the ordinary course of business as transfers for consideration that were bona fide, at arm's length, and free from donative intent. Thus, they were not subject to the gift tax.

The second case, *Carson v. Commissioner*,⁵⁶ involved contributions by the taxpayer to general campaign funds of three candidates and direct payment of campaign expenses for other candidates, all of which took place before the enactment of the provision specifically providing that the gift tax is inapplicable to transfers to political organizations. The Tenth Circuit affirmed the Tax Court's decision that the campaign contributions were not gifts under the gift tax law. It declined to adopt the *Stern* court's position that they were transfers for consideration.

Whether these cases would be held to apply to contributions to legal expense fund trusts of federal politicians is unclear. Trusts established according to the Senate model also seem to lack a demand power by the beneficiary. Thus, there is no certain protection from the gift tax to contributors of legal defense fund trusts following the Senate model.

E. Status as a Grantor Trust

Another issue is whether these legal defense fund trusts are grantor trusts. Under the grantor trust provisions of the code,⁵⁷ income is taxed to and deductions are taken by the grantor in specified situations. Regulations under section 671 specify that the term "grantor" includes any person "to the extent that such person either creates a trust, or directly or indirectly makes a gratuitous trans-

fer . . . of property to a trust."⁵⁸ Thus, not only the public official but also the contributors to the legal defense fund trust are likely to be grantors to legal defense fund trusts. The public official generally contributes only a small fraction of the funds in a legal expense fund trust. The Senate model, for example, requires the member to transfer only \$10 to establish the trust; the Presidential Legal Expense Trust, the Clintons' first legal expense trust, was established with a \$2,000 contribution from them.

While the Senate model may call the public official the grantor of the legal expense fund trusts, for tax purposes the public official is the grantor only for the limited funds he contributes. However, the official is the beneficiary of the fund. In limited circumstances, a beneficiary of a trust will be treated as the trust's owner and thus subject to the grantor trust rules under section 678. That section provides that a "person other than the grantor shall be treated as the owner of any portion of a trust with respect to which . . . such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself."⁵⁹ As discussed earlier, the public official has the power to terminate the trust and direct any funds to section 501(c)(3) organizations or to the contributors. It is unlikely that this ability to direct funds left in a terminated trust to charity is sufficient to make the trust a grantor trust under section 678, for many of the same reasons that this termination power does not make contributions to the fund a present interest. Members cannot make the funds their own.

If the income and expenses of the legal expense trust are not taxed directly to the public official under the grantor trust rules, the trust would itself be a taxable entity required to file Form 1041 and pay tax on the rules applicable to complex trusts. These rules, in general, require taxation of amounts not distributed, paid, or credited, up to the amount of distributable net income.⁶⁰ Legal expense fund trusts are not simple trusts required to distribute all income to beneficiaries annually, and they could possibly generate income. However, these legal expense funds are created on the assumption that not only contributions that constitute the trust's principal, but also any income, will be used to pay legal expenses. Legal expense fund trusts are generally established only after a public official has

⁵⁵436 F.2d 1327 (5th Cir. 1971).

⁵⁶641 F.2d 864 (10th Cir. 1981).

⁵⁷See sections 671-679.

⁵⁸Reg. section 1.671-2(e)(1). A gratuitous transfer for this purpose is "any transfer other than a transfer for fair market value," and a transfer is for fair market value "only to the extent of the value of property received by the trust, services rendered by the trust, or the right to use property of the trust." Reg. section 1.671-2(e)(2).

⁵⁹Section 678(a)(1).

⁶⁰See section 661.

encountered severe legal problems and large legal bills. Thus, it is possible that monies in the legal expense fund trust would be used almost immediately to pay legal bills and, as a result, generate little income. Ensign set up his legal expense fund trust only after spending several hundred thousand dollars of his own money and because of the heavy burden of his legal costs.⁶¹ That is, if the trust has no income, there would be no amounts taxable to the trust.

If, however, income is generated and used to pay legal expenses, additional questions arise. Regulations under section 662, the provision governing the inclusion of amounts in the gross income of trust beneficiaries, specify that “any amount which, pursuant to the terms of a will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of any person is included in the gross income of such person.”⁶² A support obligation for a minor child, for example, would be such a legal obligation. If the legal expense fund trust is not a grantor trust, we must also ask whether the amounts paid to legal counsel discharge the obligation of the public official as the trust beneficiary or of the trust itself. Under the Senate model, the senator is the beneficiary of the trust who is to receive such “tangible or intangible benefit from the Trust . . . that is incident to or may have arisen from past legal representation, but the Trust itself enters directly into any legal agreements with legal counsel selected by the member.” As discussed at length earlier, public officials will have income to the extent that another person, including a legal expense fund trust, pays their legal expenses. Thus, the official would have income to the extent that not only contributions to the trust, but also trust income, pay the official’s legal expenses. It does not seem, however, that a legal expense fund trust, assuming it is not a grantor trust, would be entitled to a deduction for paying those expenses.

As explained below, all the income tax, fiduciary tax, and gift tax uncertainties that surround current legal defense fund trusts — particularly those that

follow the Senate model — can be eliminated if the fund can and does register as a section 527 organization.

F. Section 527

A section 527 organization requires no formal structure or organization. A section 527 organization need be no more than a separate segregated fund — that is, a bank account. Section 527(f)(3) specifies that a separate segregated fund is to be treated as a separate organization. The regulations under section 527 further explain that a “political organization is not required to be formally chartered or established as a corporation, trust, or association” and that a separate segregated fund “is a fund which is established and maintained by a political organization or an individual separate from the assets of the organization or the personal assets of the individual.”⁶³ While formal organization is not required, the quoted language from the regulations also makes clear that a trust can be a section 527 organization.

Section 527 serves two quite different functions. First, it specifies the extent to which all political organizations are subject to income tax. In general, under these rules political organizations are not subject to tax on income or expenses related to campaigns for office — income that the statute calls “exempt function income.” Any amounts that are not exempt function income, which most often consists of investment income but also includes personal expenses of the public official, are subject to tax.⁶⁴ Second, section 527 provides registration and disclosure rules for political organizations that are subject to regulation by the IRS. These are generally those political organizations that are not subject to regulation by the FEC or by state law.

G. Definition of Exempt Function Income

The statute defines a political organization as “a party, committee, association, fund or other organizations (whether or not incorporated) organized and operated primarily for the purpose of directly

⁶¹Steve Tetreault and Jeff German, “Ethics Probes: Ensign Starts Fund to Pay His Legal Fees,” *Las Vegas Review-Journal*, June 2, 2010, available at <http://www.lvrj.com/news/ensign-starts-fund-to-pay-his-legal-fees-95440954.html>. Ensign did so because “putting on a defense like this takes huge amounts of hours from lawyers, and it turns up huge bills.” *Id.* In the second half of 2010, the Ensign 527 organization took in more than \$120,000. John Ralston, “Ensign’s legal defense fund mostly funded by current, former gamers,” *Las Vegas Sun*, Mar. 6, 2011, available at <http://www.lasvegassun.com/blogs/ralstons-flash/2011/mar/06/ensigns-legal-defense-fund-mostly-funded-current-f/>.

⁶²Reg. section 1.662(a)-4.

⁶³Reg. section 1.527-2(a)(2) and (b). The regulation continues, “A savings or checking account into which only contributions to the political organization are placed and from which only expenditures for exempt functions are made may be a segregated fund.” It cautions, however, that if a separate segregated fund “expends more than an insubstantial amount from the segregated fund for activities that are not for an exempt purpose during a taxable year, the fund will not be treated as a segregated fund for such year.” Reg. section 1.527-2(b).

⁶⁴Also, section 527 specifies rules regarding the taxation of electioneering expenditures by section 501(c) organizations that are permitted to engage in electioneering, such as section 501(c)(4), (5), and (6) organizations. Under section 527(f), these organizations are subject to tax on the lesser of their investment income or electioneering expenditures.

or indirectly accepting contributions of making expenditures, or both, for an exempt function.”⁶⁵ This definition is broad enough to cover legal defense funds, if legal defense funds accept contributions or make expenditures for an exempt function. The term “exempt function” is defined as:

the function of 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, whether or not such individual or electors are selected, nominated, elected or appointed. *Such term includes the making of expenditures related to an office described in the preceding sentence which if incurred by the individual, would be allowable as a deduction under section 162(a).*⁶⁶

Importantly, section 527 is not limited to those elected to office; it includes appointed officials as well.⁶⁷ Thus, if legal defense funds are permissible section 527 organizations, they could be established for executive and judicial branch officials as well as legislators and elected judges.

Whether legal defense funds can be political organizations turns on the meaning of the second sentence regarding expenditures allowable as a deduction under section 162(a). If those expenditures qualify as being made for an exempt function, section 527(c) provides that exempt function income is not included in the definition of taxable income and that exempt function income includes a contribution of money or other property received by the section 527 organization.⁶⁸

The sentence defining exempt function to include expenditures that would be deductible under section 162(a) and exempt function was added to section 527(e) by the 1988 Technical and Miscellaneous Revenue Act (TAMRA).⁶⁹ Before its adoption, IRS rulings had made clear that campaign funds used for non-campaign-related expenses were includable in the income of a section 527 organization.

Rev. Rul. 80-331⁷⁰ concluded that surplus campaign funds transferred to an officeholder’s office account, which are permitted under the Federal Election Campaign Act, are includable in the officeholder’s gross income. It also concluded that amounts disbursed from the office account for ordinary and business expenditures are deductible under section 162(a).

In reaching its conclusion, the ruling quoted legislative history regarding section 527(d), which specifies when amounts transferred from a political organization are not treated as diverted for the personal use of a candidate or any other person.⁷¹ After explaining that amounts diverted to personal use are taxable income in the year of the diversion, the legislative history specified: “When excess campaign funds are transferred to an office account, they are diverted for the personal use of the officeholder because the transfer is not an exempt function as defined in section 527(e)(2) of the Code and because the transfer is not a contribution or deposit described in section 527(d).”⁷² Rev. Rul. 87-119⁷³ explained that amounts spent from campaign funds for food for campaign staff to discuss legislation after an election did not constitute an exempt function expenditure under section 527, because work on legislative items is part of the elected official’s trade or business rather than part of the selection process. As a result, the amounts were includable in the official’s gross income but could be deducted to the extent permitted under sections 67, 162, and 274.

The 1988 amendment expanding the definition of exempt function under section 527 provoked controversy after its adoption. One article described it as prompting “murmurings that lawmakers may have feathered their nest a bit” and stated that some sources charged “that the congressional taxwriting committee attempt to mask the provision” in accompanying committee reports.⁷⁴ Gregory L. Colvin criticized it as “peculiarly self-interested” and as overturning Rev. Rul. 80-331 and Rev. Rul.

⁶⁵Section 527(e)(1). Contributions to section 527 organizations are not deductible.

⁶⁶Section 527(e)(2) (emphasis added).

⁶⁷See *infra* note 104 for criteria to determine what constitutes a “public office.”

⁶⁸Section 527(c)(1)(A) and (3)(A). Investment income, however, is subject to tax. Section 527(c). There is a specific deduction of \$100. Section 527(c)(2)(A). As discussed above, legal expense fund trusts may generate little investment income. Moreover, nothing in section 527 prevents political organizations from investing only in tax-exempt bonds to avoid investment income.

⁶⁹P.L. 100-647, section 1001(b)(3)(B).

⁷⁰1980-2 C.B. 29.

⁷¹Under section 527(d), amounts are not treated as income to the officeholder if they are contributed to another section 527 organization, to a public charity, or deposited in the general fund of the Treasury or any state or local government.

⁷²Rev. Rul. 80-331, quoting S. Rep. No. 93-1357 at 30 (1974), 1975-1 C.B. 517, 534. Similarly, reg. section 1.527-5(a) provides that amounts for the personal use of any individual that are not for an exempt function will be income to that individual, and it gives payment of a candidate’s federal income tax liability as an example.

⁷³1987-2 C.B. 151.

⁷⁴Sean Ford, “TAMRA Said to Have Opened Sizable Loop-hole in Campaign Spending Rules,” *Tax Notes*, Aug. 28, 1989, p. 958.

87-119. He wrote, "The phrase 'relating to a public office' broadens the exempt function of a political committee, so that it reaches beyond the campaign or political selection process. . . . Political committee funds are now available for any deductible business expense of a public office holder, with no Federal tax restrictions on the committee."⁷⁵ He faulted the House Ways and Means Committee report for referring to the section 527 change as simply a conforming change to clarify the section 62 rule regarding reimbursements so that an employee could treat reimbursements from either employers or a third party as an above-the-line deduction under section 62.⁷⁶ He deemed the new provision a great boon to incumbents.

According to reports, an IRS official agreed with Colvin that congressional taxwriters were aware of the change effected by the amendment, although aides on the House and Senate tax committees disputed any attempt to mislead and could not recall who had requested the amendment.⁷⁷ Also, sources at the IRS confirmed at the time that the amendment appeared to supersede Rev. Rul. 80-331 and Rev. Rul. 87-119.⁷⁸

Nonprecedential guidance has confirmed that position. An IRS Exempt Organizations Division continuing professional educational text for 1990 states that the amendment effectively revoked the position taken in the two revenue rulings. It explained further that under the provision, "a political organization's funds may be used for any deductible business expense of a public officeholder

⁷⁵Gregory L. Colvin, "TAMRA Quietly Reversed IRS Policy Taxing Transfers of Campaign Funds to Public Officeholders," *Tax Notes*, July 24, 1989, p. 457.

⁷⁶The example given is that of a state-elected official reimbursed by an account authorized under state law to pay office expenses. "To the extent those expenses are otherwise deductible business expenses and the reimbursement does not exceed those expenses," the Ways and Means Committee report explains, "the state official would be permitted an above the line deduction for those expenses." Ford, *supra* note 74. Jasper L. Cummings, Jr., has argued that critiques of the amendment are misplaced and that the example in the legislative history is in fact a useful guide. He puts forth a narrow view of the amendment that interprets it to mean the following: "A political campaign fund can be expended for the office holder only in the rather limited circumstances in which the fund 'incurs' the expense as well as pays it; if the office holder incurs the expense and obtains reimbursement from the fund, he includes the reimbursement in his gross income and he can claim a section 162 deduction above-the-line (and not report on his tax return the income and offsetting deduction at all)." Cummings, "Payment of an Incumbent's Office Expenses by a Political Campaign Fund: A Dissenting View," *Tax Notes*, Oct. 21, 1991, p. 359. He acknowledges, however, that no one is likely to complain about the broad view of the amendment others have taken.

⁷⁷Ford, *supra* note 74.

⁷⁸*Id.*

— to be considered an 'exempt function' expenditure, the funds need not be used only for activities relating to the officeholder's 'selection process'; they may be used for expenses relating to the office held by the transferee that would constitute an allowable business deduction."⁷⁹ TAM 9320002⁸⁰ notes that the example in the section 527 regulations stating that expenditures for periodicals to keep informed on national and local issues are not for an exempt function "no longer applies in the case of an officeholder's business expenses." TAM 9409003⁸¹ concludes that expenditures for an employee Christmas party, maps for use in the officeholder's office, and expenditures for the officeholder's employees to attend a national convention directly related to their job would all be ordinary and necessary business expenses deductible under section 162(a) and thus also would be exempt function expenditures under section 527(e)(2).

The IRS, in a 1999 field service advice, described the purpose and function of the amendment as remedying a problem resulting from the enactment of the 2 percent floor on miscellaneous itemized deductions:

Before the 1986 Tax Reform Act, an office holder's expenses which were paid or reimbursed by a section 527 organization were clearly income to the office holder. Since the expenses were deductible by the office holder as section 63(d) itemized deductions, there was generally no net tax effect to the office holder. The enactment of the section 67 2 percent floor on itemized deductions by the 1986 Tax Reform Act, however, meant that the office holder often could not deduct all or some of these expenses. This problem was remedied by TAMRA, section 1001(b)(3)(B), which amended section 527 (e)(2) to provide that payment of an office holder's section 162(a) expenses is an exempt function.⁸²

The field service advice suggests, but does not definitively conclude, that amounts from a section 527 organization will not be income to the officeholder: "Since Treas. Reg section 1.527-(a)(1) states that an exempt function expenditures is not income

⁷⁹IRS Exempt Organizations, *Continuing Professional Education Technical Instruction Program Textbook*, Ch. D, "Update on Political Activities" (1990), Doc 94-187, 94 TNT 54-72. By the same reasoning, reg. section 1.527-2(3)(ii), which lists paying an incumbent's office expense as an example of an activity that is not an exempt function, is also no longer the law. The regulation was amended in 1985 but has not been amended since the 1988 adoption of the amendment to section 527(e)(2).

⁸⁰93 TNT 110-17.

⁸¹94 TNT 44-17.

⁸²FSA 1999-961, Doc 1999-2402, 1999 TNT 70-25.

to the office holder who receives its benefits, the payment of section 162(a) expenses arguably will not be income to the office holder."⁸³ Another 1999 ruling, which concluded that a proposed organization would qualify as a political organization under section 527, addresses litigation expenses directly: "Litigation on a matter affecting the public's perception of the candidate's fitness for public office with respect to the candidate's or office-holders conduct of official governmental functions, so long as it related to the conduct of official duties is, by reason of section 162(a) and Rev. Rul. 74-394, . . . an exempt function within the meaning of section 527(e)(2)."⁸⁴

In sum, a legal defense fund accepting contributions to and making expenditures for litigation or investigations of a public official for proceedings related to the office can be a political organization under section 527. A political organization must be organized and operated primarily for an exempt function as defined in section 527(e)(1). The 1988 amendment to section 527(e) added expenditures deductible by an individual under section 162(a) to the definition of exempt function. Several authorities, including Rev. Rul. 74-39, discussed above, treat legal defense expenses of an officeholder for proceedings related to the office as deductible under section 162(a). A fund organized and operated exclusively to collect contributions for and make expenses for a public official's legal defense can therefore qualify as a section 527 organization. As discussed below, being a section 527 legal defense fund offers a number of tax advantages, including certainty regarding tax treatment, but also subjects the fund to IRS regulation and disclosure obligations.

H. Consequences of Being a Section 527 LDF

If a legal defense fund becomes a section 527 organization, exempt function income is not subject to tax.⁸⁵ Exempt function income includes "contributions of money or other property . . . to the extent such amount is segregated for use only for the exempt function of a political organization."⁸⁶ As a result, contributions to a section 527 legal defense

fund would not be subject to tax,⁸⁷ without any need to consider the matching of income and deductions. That is, section 162(a) is relevant only for the purpose of characterizing the fund as a political organization under section 527, not for the purpose of actually taking any deductions. Since any income is not deemed to have been distributed to or to have been income of the officeholder, but is simply exempt from tax, the officeholder for whose benefit a section 527 legal defense fund is established need not be concerned about the 2 percent limit of section 67 on miscellaneous itemized deductions or the possible application of the AMT. With a legal defense fund organized as a section 527 organization, the officeholder can avoid income tax liability.

A section 527 legal defense fund also avoids any issues related to the gift tax. Under section 2501(a)(4), transfers to a political organization as defined in section 527(e)(2) are not subject to the gift tax. As a result, with a section 527 legal defense fund, there is no occasion to structure a legal defense fund so that the officeholder-beneficiary has a present interest, as the second Clinton legal defense fund provided, to enable gifts to qualify for the annual exclusion. Establishing a legal defense fund as a section 527 organization will thus ensure that contributors will not be subject to gift tax liability or use any of their unified credit against the gift tax, without having to structure the trust so that the present interest requirement is satisfied.

In sum, establishing a legal defense fund as a section 527 organization offers considerable income tax benefits. Aside from investment income above \$100, if any, the section 527 organization itself will not be subject to tax. The officeholder will not face income tax liability as a result of the fund collecting and spending amounts for his legal expenses.⁸⁸ A section 527 legal defense fund also provides additional assurance that contributions to the fund will not subject the contributors to gift tax.

I. Becoming and Operating as a Section 527 LDF

Section 527 provides a set of regulatory requirements for organizations that meet the definition of political organization but are not regulated by the FEC or by the states.⁸⁹ As discussed earlier, the FEC

⁸³*Id.* The previously discussed CPE text, by stating that the new provision overrules Rev. Rul. 80-331 and Rev. Rul. 87-119, further supports the argument that those amounts are not income to the officeholder.

⁸⁴"Political Organization Receives Favorable Letter Ruling," *Doc 1999-15586*, 1999 TNT 83-22. The ruling was later released as LTR 199925051, *Doc 1999-22051*, 1999 TNT 123-48.

⁸⁵Section 527(c)(1). Contributions to section 527 organizations are not deductible.

⁸⁶Section 527(c)(3).

⁸⁷Investment income exceeding \$100 would be taxable, however. Section 527(c). Investment income and any amounts used for other than exempt function, such as any contributions used for purely personal purposes rather than litigation expenses, would also be taxable.

⁸⁸There could be income tax liability if excess funds are distributed in ways other than those specified in the statute. See *infra* note 107.

⁸⁹An organization that reasonably anticipates it will not have gross receipts of \$25,000 or more for the tax year is exempt from registration requirements, and those that do not anticipate gross

(Footnote continued on next page.)

has announced that contributions to legal defense funds similar to Ensign's are not subject to its regulation. While states in some cases regulate these legal defense funds,⁹⁰ state rules will vary considerably from state to state and do not apply to federal officials, who are the focus of this article. Section 527 legal defense funds established for federal officeholders would be subject to the regulatory regime of section 527 as well as its tax provisions.

A section 527 organization subject to regulation by the IRS must give electronic notice to the IRS within 24 hours after it is established or within 30 days of any material change.⁹¹ If the organization fails to do so, exempt function income received before the giving of that notice is subject to tax at the highest corporate rate. That is, section 527 organizations subject to IRS regulation will not be exempt from income tax unless they provide electronic notice, which is done by filing Form 8871. These forms are publicly available on a searchable IRS database.⁹²

Also, section 527 organizations must file reports on Form 8872 disclosing either expenditures or contributions if they have reason to believe that total contributions or expenditures will exceed \$50,000 in a calendar year.⁹³ Expenditure disclosures apply when expenditures to any person equal or exceed \$500 during a calendar year, and the disclosures must include the amount, date, and purpose of each such expenditure, along with the name and address of the person (and for individuals, the individual's occupation and name of employer).⁹⁴ Contribution disclosures apply if the contributions for the calendar year equal \$200 or more, and they must include the date of the contribution, the name and address of the contributor, and in the case of an individual, the individual's occupation and name of employer.⁹⁵ In even numbered (election) years, section 527 organizations must file these reports either quarterly or monthly, but must file on the same basis for the entire

calendar year.⁹⁶ Pre- and post-election reports are also required. In odd-numbered years, the organization may file reports either semiannually or monthly, but again must file on the same basis for the entire calendar year.⁹⁷ The reports are also available on the IRS searchable database.

These disclosure requirements would be in addition to any imposed by other bodies, such as the House and the Senate. Although the IRS's administration of section 527's registration and disclosure requirements has received considerable criticism,⁹⁸ the searchable databases maintained by the IRS are more easily available to the public than reports filed with the Senate and House. The documents available on the searchable site include not only the registration and disclosure forms, but also the political organization's annual information return on Form 990. Thus, establishing a legal defense fund as a section 527 organization could mean greater scrutiny of contributions and expenditures by both the public and journalists.

J. Examples of Section 527 LDFs

A search of the IRS section 527 database did not reveal any legal defense funds registered under section 527 for federal officials other than Ensign, but it did disclose two such legal defense funds for state officeholders, both from Wisconsin and both charged in connection with the same 2002 scandal relating to the use of state resources for campaigns. Former Republican Wisconsin State Assembly Speaker Scott Jensen was convicted of three felonies in 2006 on these charges, but the convictions were overturned on appeal and he currently is facing retrial.⁹⁹ Former Democratic State Senator Brian Burke accepted a plea agreement and was convicted of one felony and one misdemeanor.¹⁰⁰

The notice of section 527 status (Form 8871) for the Brian Burke Legal Defense Fund is dated July 12, 2003. It describes its purpose in the most general of language: "To receive and expend funds so as to influence or attempt to influence the selection, nomination, election or appointment of Brian Burke to public office, and to fund expenses relating to

receipt of \$50,000 or more are exempt from disclosure requirements. Section 527(i)(5)(B) and (j)(7).

⁹⁰See Matthew Haverstick, "On the Taxpayer's Dime: Indemnity Rights for Public Officials Accused of Crime," Bloomberg Law Reports, available at [http://www.conradobrien.com/SiteData/doc/on%20the%20taxpayers%20dime%20\(2\)/996dc66ee4190ae06679305df0d2e1b9/on%20the%20taxpayers%20dime%20\(2\).pdf](http://www.conradobrien.com/SiteData/doc/on%20the%20taxpayers%20dime%20(2)/996dc66ee4190ae06679305df0d2e1b9/on%20the%20taxpayers%20dime%20(2).pdf).

⁹¹Section 527(i).

⁹²See <http://forms.irs.gov/politicalOrgsSearch/search/baSearch.jsp?ck>.

⁹³Section 527(j)(7).

⁹⁴Section 527(j)(3)(A).

⁹⁵Section 527(j)(3)(B).

⁹⁶Section 527(j)(2)(A).

⁹⁷*Id.*

⁹⁸See Lloyd Hitoshi Mayer, "The Much Maligned 527 and Institutional Choice," 87 *B.U. L. Rev.* 625, 635 n.45 (2007); "TIGTA Says IRS Hasn't Fully Addressed Political Organization Noncompliance," *Doc 2010-18850*, 2010 TNT 165-23.

⁹⁹John Nichols, "Meet Scott Jensen — the Lindsay Lohan of Wisconsin Politics," *CapTimes*, Oct. 28, 2010, available at http://host.madison.com/ct/news/opinion/column/john_nichols/article_c626f8c2-a023-5e0a-8382-3de439b83f7d.html.

¹⁰⁰Mike Johnson, "Jensen Defense Seeks Records; Attorneys Want Papers on Probe of Democrats," *Milwaukee Journal Sentinel*, Sept. 14, 2010, at NaN.

and arising out of such elective office.” According to its Forms 990,¹⁰¹ the amounts involved were modest — a little more than \$16,000 in 2002 and a bit more than \$15,000 in 2003. Most of the funds came from Burke’s campaign fund, and all the expenses went to attorney fees.

The Scott Jensen Legal Defense Fund was established on October 11, 2002. It also described its purpose in general language: “To be organized and operated primarily for political purposes within the meaning of Internal Revenue Code Section 527, and, more specifically, to accept contributions and expend such amounts for the purpose of (i) influencing and/or attempt to influence the selection, nomination, election or appointment of Scott Jensen to public office, and (ii) funding expenses relating to and arising out of such elected public office, as provided in Internal Code Section 527(e)(2).” As with the Brian Burke Legal Defense Fund, most of the contributions come from the officeholder’s campaign fund; in Jensen’s case the amount transferred from his campaign was more than \$250,000 as of June 30, 2007, the last date for which documents appear on the IRS website. The only other significant contributor was Jensen himself, who gave the fund a little more than \$40,000 during that period.

Thus, there is precedent for Ensign establishing his legal expense fund as a section 527 organization. According to press reports, Ensign funded his legal expense fund in May 2010 with \$10 that he contributed himself.¹⁰² In doing so, he followed the Senate trust model for legal expense funds. The Ensign Legal Expense Trust Fund’s Form 8871 is dated August 2, 2010. The stated purpose of the Ensign Legal Expense Trust Fund is far narrower than those established by the Wisconsin state politicians. Its Form 8871 states: “The sole purpose of the Trust is to receive funds and to pay all expenses reasonably related to the legal representation of the Grantor in connection with legal inquiries, including by the Select Committee on Ethics of the United States Senate and the United States Department of Justice, involving allegations of violations of the Standing Rules and Standards of the Senate and Federal Statutes, relating to or arising by virtue of the Grantor’s service in or to the United States Senate.”

By registering the Ensign Legal Expense Trust Fund as a section 527 organization, Ensign ensures

that all the funds donated to it (other than the \$10 he contributed to establish it and any other funds contributed before August 2) will be treated as being contributed directly to the section 527 organization and therefore qualify as exempt function income under section 527. As a result, Ensign ensures that he does not face any income tax liability caused by the mismatch between includable income and allowable deductions that plagues legal defense funds not registered as section 527 political organizations. He also ensures that contributions to the legal expense fund trust will not be subject to the gift tax.

III. A Call to Amend House and Senate Rules

The Senate rules regarding these funds go back to at least 1980, before the current AMT and the adoption of section 67 with its 2 percent floor for itemized miscellaneous deductions, including unreimbursed employee expenses. That is, the rules date back to a time when any income from contributions to a legal expense fund trust could be offset without limitation by business expense deductions of expenditures for legal defense. Neither the House nor the Senate appears to have considered the current substantial tax liability a legal expense fund trust might impose on members or the potential gift tax liability for contributors. The House and Senate rules regarding legal defense funds also fail to contemplate explicitly using a section 527 organization to collect and disburse those funds, even though the 1988 amendments to section 527 that permitted that structure preceded the current House rules, which date back to 1996, and occurred only a few months after adoption of the current Senate rules.¹⁰³

The rules of both the Senate and House should be revised to explicitly permit — and encourage — establishing legal expense funds as section 527 organizations. The OGE should permit section 527 legal defense trusts in appropriate situations as well.¹⁰⁴ Doing so would render moot many of the

¹⁰¹The Brian Burke Legal Defense Fund filed a Form 990 as a section 527 organization for 2002, although there is no Form 8871 in the IRS database registering the fund as a section 527 in 2002.

¹⁰²Tetreault and German, *supra* note 61. He did so after spending several hundred thousand dollars of his own money. *Id.*

¹⁰³TAMRA was signed by the president on November 10, 1988, and the Senate rules for legal expense fund trusts were amended in August 1988.

¹⁰⁴Section 527 applies to appointed officeholders as well as elected ones, as long as the officeholder is a public official. The section 527 regulations specify that the determination of who is a public official is one of facts and circumstances, but that principles consistent with those under reg. section 53.4946-1(g)(2) will apply. Reg. section 1.527-2(d). Reg. section 53.4946-1(g)(2) provides that in making the determination that a person fills a public office rather than being a mere employee, “the essential element is whether a significant part of the activities of a public employee is the independent performance of policy-making functions.” The regulation further provides that such a position may exist in the legislative, judicial, or executive

(Footnote continued on next page.)

tax uncertainties and burdens connected with legal expense fund trusts. As amended in 1988, section 527 permits the use of section 527 organizations for that purpose. The amendment, as the IRS has explained, eases the harsh consequences of current limits on deductions. The contribution, expenditure, and other disclosures required by section 527 organizations for inclusion in a searchable database will increase transparency regarding the operation of these funds, although the timing of reports differs under the two sets of rules, and thresholds for reporting are in some cases higher for section 527 organizations than under the House and Senate rules.¹⁰⁵ Allowing a defense fund to register and operate as a section 527 organization does not require the House and Senate to eliminate their reporting requirements or contribution limits. Members establishing section 527 legal defense funds would have to satisfy both sets of rules.

Some of the current congressional rules for legal defense trusts would require changes to permit section 527 legal defense funds. While the Senate rules permit any excess funds to be donated to charity, which is permissible under section 527, the House rules require that excess contributions be returned to contributors. Under section 527, however, excess funds are generally "treated as expended for the personal use of the person having control over ultimate use of such funds"¹⁰⁶ and thus are income to that person unless transferred in specified ways that do not include return to contributors.¹⁰⁷ To enable easy compliance with section 527, the House rules should, like the Senate rules, permit transfers to a charity.

The House and Senate rules for section 527 legal expense funds could also include protections beyond those required by section 527. In the case of the Brian Burke section 527 legal defense fund, Burke listed himself as the authorized official, cus-

todian of records, and contact person. No provisions of section 527 or the section 527 regulations forbid the public official from holding those positions. Just as current rules require a trustee other than the member for legal defense trusts, however, the House and Senate rules could require that a person other than the member hold these positions even if the organization does not organize as a trust. Similarly, although there are no limits on contributions to section 527 organizations regulated by the IRS, the House and Senate could continue to enforce their limits.

Making changes to House and Senate rules to permit section 527 legal defense funds would be worth the effort. Current law permits them. Their establishment would benefit individual members by insulating them from income tax liability or uncertainty about that liability without endangering the protections that the House and Senate rules seek to establish. These changes would not undermine the purpose of the 2 percent floor of section 67 to ensure that personal or mixed personal and business expenses are not deducted as business expenses, because House and Senate rules as well as federal election law require that legal expense funds be used only in connection with official duties and not for personal use.

IV. Conclusion

We may well decry the seemingly self-interested amendment of section 527 to give members of Congress an escape from the 2 percent floor of section 67 that is unavailable to the rest of us taxpayers. Given the amendment of section 527(e) in 1988 to include the making of section 162(a) expenditures within the definition of exempt function, however, the use of section 527 legal defense funds for legal proceedings relating to an officeholder's election to office or official duties while in office comes within both the spirit and intent of the statute. Thus, it is surprising that the House and Senate have not amended their own rules and regulations to permit and encourage the use of section 527 for legal defense funds. By not doing so, they have left in place rules regarding legal defense trusts that could expose members establishing these trust funds to large tax liabilities. Failure to pay income taxes due and owing on those funds could itself be the occasion for yet another ethics investigation of the member. The House and Senate ethics committees can avoid these problems by amending their rules to explicitly permit section 527 legal expense funds. They should do so. That task is surely easier than amending section 527 itself or our campaign finance laws, however much some would prefer to see fundamental changes to the regulation of political organizations.

branch. One important additional factor discussed in the regulation is whether the office is created by Congress and whether the duties to be discharged are defined either directly or indirectly by Congress.

¹⁰⁵As noted earlier, the House requires disclosure of all contributions and expenditures of \$250 or more and all contributions from corporations and unions, while the Senate has a much lower threshold of only \$25 per year for those disclosures. Under section 527, contributions of \$250 or more annually and expenditures of \$500 or more annually must be disclosed. See *supra* Part I.A.

¹⁰⁶Reg. section 1.527-5(c)(1). See section 527(d).

¹⁰⁷In addition to transfers to charities, permissible transfers for excess funds include transfers to other section 527 organizations, to charity, to the general fund of the treasury, or the general fund of any state or local government, or held "in reasonable anticipation of being used for by the political organization for future exempt functions." Reg. section 1.527-6(b) and (c).