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Exempt Organizations

Montana Must Prove Harm, Law Violation in IRS Donor Rules Suit

BNA Snapshot

- IRS says it has authority to change policy despite law governing rulemaking process
- State must prove it was harmed by elimination of donor disclosure requirement, pros say

By Robert Lee, Lydia O'Neal, and Carolina Vargas

Montana Gov. Steve Bullock (D) must prove two things in his lawsuit against the IRS's decision to stop collecting donors' identities from some nonprofit groups—that the state is harmed by the action and that the agency violated a 54-year-old law governing how regulations are made.

Attorneys disagree about the prospects for success.

The law, the Administrative Procedure Act, is one that other Democratic state leaders have cited in a number of lawsuits against Trump administration actions, alleging that agencies violated the APA's requirements for developing and issuing regulations.

Bullock's complaint says the Internal Revenue Service failed to follow the APA when it issued Revenue Procedure 2018-38, revoking a requirement that tax-exempt unions, business leagues, and "social welfare" nonprofits organized under tax code Section 501(c) report the names and addresses of their donors to the agency. Political campaign groups organized under Section 527 were left out, as were 501(c)(3)s, most of which are churches or charities.

Pro-transparency groups, and Bullock himself, have warned that allowing groups to hide their donors from the IRS could keep the agency from enforcing the ban on foreign contributions to U.S. political campaigns. Libertarian and conservative groups—some of which lobbied for the policy change—have described the issue as one of personal privacy and freedom of speech, pointing to reports of the IRS targeting groups for scrutiny based on their political leanings. Others say the agency simply doesn't have the resources to audit many of these groups anyway.

Bullock's office is encouraging other states to consider joining the suit, spokeswoman Ronja Abel told Bloomberg Tax in a July 26 email.

"This is a legislative rule change that should have gone through the APA's notice-and-comment process," Abel said. The regulations have been around since the Nixon era, she said, and there may be impacts downstream beyond those affecting state tax authorities.

The IRS referred a request for comment to the Treasury Department, which deferred to the Justice Department, which declined to comment.

'Full-Throated Justification'

Montana's claim that the IRS violated the APA is "strong," Daniel Hemel, an assistant professor of law at the University of Chicago, told Bloomberg Tax July 26. Hemel, who said he was one of several advisers for Bullock's lawsuit, said the agency needs to give a "more full-throated justification for its decision" while allowing states and other stakeholders the opportunity to comment.

Even conservative organizations that lobbied lawmakers to review exempt organizations' filing requirements suggested to the

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administration that the IRS should eliminate the disclosure requirement through rulemaking, which would imply a required public comment period, Hemel said.

In Rev. Proc. 2018-38, the IRS cited past regulations and revenue procedures in asserting that the commissioner has authority “to grant relief” to all types of tax-exempt organizations if he or she finds the information unnecessary for tax administration.

The problem with that argument, Hemel said, is that the APA, a statute, governs IRS regulations. “In Montana's view, you can't by regulation turn off the Administrative Procedure Act,” he said.

The IRS could have taken a “much more judicious approach” by either amending the existing regulation or seeking to withdraw it and opening such action to a notice and comment process, Juan F. Vasquez Jr., a shareholder and co-chair of the tax controversy section at Chamberlain Hrdlicka's Houston office, told Bloomberg Tax.

“The fact that the IRS essentially is telling organizations that they now don't have to comply with those regulations which have been on the books and went through the APA's notice and comment process seems to be an end run around the very important and critical notice and comment process,” Vasquez said.

Other practitioners aren't so sure about the APA argument. “You can't generalize about the procedural propriety of revenue procedures,” Jeffrey Tenenbaum, a nonprofit attorney at Lewis Baach Kaufmann Middlemiss PLLC in Washington, told Bloomberg Tax. “It depends on the substance of the revenue procedure.”

Tenenbaum said Montana's APA position “may be a bit of a stretch.” The lawsuit, filed July 24 in the U.S. District Court for the District of Montana, “certainly highlights the fact this seems to be a political dispute dressed up in procedural arguments—on both sides,” he said.

Proving Legal Standing

Still, Tenenbaum said, states “absolutely” have a legitimate argument for the IRS to provide them with information they need to enforce their own standards for entities’ tax-exempt status.

The lawsuit says the Montana Department of Revenue—a plaintiff, along with Bullock—“relies on the availability” of the nonprofits’ donor disclosure information, because Montana law doesn't require tax-exempt organizations to provide names and addresses of significant contributors.

But states can have a hard time explaining how the collection of donor information helps them administer their laws, particularly because of the strong interest donors have in maintaining privacy, Alexander Reid, a partner at Morgan Lewis & Bockius LLP in Washington who advises tax-exempt organizations, told Bloomberg Tax.

Donor information provided to the IRS is confidential precisely because of concerns that states might use it to retaliate against taxpayers donating to nonprofits disfavored by state governments—as Alabama once sought to do to the NAACP, Reid said in an email.

“A judge might reasonably ask Montana: ‘If you need the donor information so badly, why don't you just ask for it instead of relying on the federal government?’” Reid said.

The state could change its laws, mandating that certain groups file the information to Montana authorities directly, as New York and California do, said Tara Malloy, senior director of appellate litigation and strategy at the Campaign Legal Center in Washington. Given the ability of states to do this, she added, the IRS policy change was “not a complete door-shutting” on access to that information, however resounding its effects may be on enforcement of campaign finance laws.

This question was an issue raised in Texas v. United States (2015), a case in the U.S. Court of Appeals for the Fifth Circuit in which several states had sued to block implementation of the Deferred Action for Parents of Americans program, Hemel said.

The Obama administration argued that states, which had raised concerns about losing revenue because of DAPA implementation, should be denied standing because they could conceivably change their laws to minimize the impact, Hemel said. The Fifth Circuit ruled, and the Supreme Court later upheld, that the states couldn't be denied standing based on that argument, Hemel said. “While it's not definitive precedent, the ruling provides persuasive evidence that states don't need to change their laws in order to minimize injury from the federal government,” he said.

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In addition to proving that such a law change would be costly, Montana will also have to show that it has used the IRS donor information to regulate its tax-exempt entities, something that “wasn't clear from the complaint,” Malloy said.

Both factors will help Bullock and the Montana DOR establish standing, tax professionals said.

“Montana needs to convince a court that they have a right that's being violated,” said Beverly Moran, a professor of federal income tax at Vanderbilt University Law School. For example, someone can't go to a court alleging breach of contract, she explained, if that person wasn't party to the contract.

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