August 5, 2013

Hon. Daniel Werfel
Acting Commissioner, Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

Dear Commissioner Werfel:

    Common Cause and the Center for Media and Democracy write to request an immediate investigation into the American Legislative Exchange Council’s massive underreporting of payment for state lawmakers’ travel on its Form 990s, filed with the Internal Revenue Service.

    The text of this letter substantially tracks the memorandum in support of the Supplemental Submission to the IRS Whistleblower Office filed by Robert Edgar on behalf of Common Cause on July 29, 2013. That document was prepared by Eric Havian, Erika Kelton & Melinda Koster of Phillips & Cohen LLP. Mr. Edgar submitted a Form 211 (“Original Submission”) pursuant to the Tax Whistleblower Act on behalf of Common Cause on April 29, 2012 documenting massive underreporting of lobbying activities by the American Legislative Exchange Council (ALEC).

    The complaint and this letter draw on information from Buying Influence: How the American Legislative Exchange Council Uses Corporate-Funded “Scholarships” to Send Lawmakers on Trips With Corporate Lobbyists, an investigative report prepared by the Center for Media and Democracy, Common Cause, and D.B.A. Press using data obtained through open
records requests and other research to document extensive spending on lawmakers’ travel (attached).

For several years, ALEC denied on its Form 990s that it funded state lawmakers’ travel. More recently, in its 2010 and 2011 Form 990s, ALEC significantly underreported its funding of state lawmakers’ travel. ALEC labels the money that it earmarked for lawmakers’ travel expenditures as “scholarship funds,” and the organization maintains that it is merely acting as an agent of these scholarship funds. The reality, however, is that ALEC’s payments for lawmakers’ travel constitute gifts, rather than scholarships, and ALEC is directly involved in fundraising for and distributing these gifts. The following sections detail the nature of ALEC’s scholarship scheme, discuss ALEC’s misrepresentations to the IRS, and explain how the organization’s travel subsidies confer a private benefit upon state lawmakers and corporate donors in contravention of the organization’s 501(c)(3) status.

This letter references documents submitted along with Common Cause’s Original Submission in April 2012 as well as the July 2013 Supplemental Submission. Exhibit numbers track those submissions, and all exhibits can be found at www.commoncause.org/alec.

I. ALEC MISREPRESENTED ITS EXTENSIVE FUNDING OF STATE LAWMAKERS’ TRAVEL AND FILED NUMEROUS FRAUDULENT TAX RETURNS IN VIOLATION OF THE INTERNAL REVENUE CODE


Since 2006, ALEC has raised and spent an estimated $4 million in scholarship funds from corporate donors to pay for state legislators’ trips to meet with lobbyists and CEOs at ALEC conferences. See Ex. 19 at 13. ALEC’s scholarship fund does not grant scholarships in the conventional sense. Far from providing an educational opportunity for meritorious applicants, these scholarships provide a mechanism for state lawmakers to meet with lobbyists
and corporate CEOs, the very people who financed their trips. ALEC’s conferences are held three times annually, and they typically take place at vacation destinations, like San Diego and New Orleans, and at luxury hotels, like the Ritz Carlton and the Hyatt Regency. \textit{Id.} at 14; \textit{see also id.}, Appendix 2. Contributions to ALEC’s scholarship fund pay for lawmakers’ airfare, hotel rooms, and meals in connection with these meetings. \textit{Id.} at 3. ALEC’s extensive funding of state lawmakers’ travel should be disclosed in its IRS filings, yet the organization has concealed its scholarship scheme through deceptive reporting tactics.

The IRS requires 501(c)(3) organizations to disclose any payments for public officials’ travel or entertainment expenses. Specifically, Part IX of Form 990 includes a line entry for “Payments of travel or entertainment expenses for any federal, state, or local public officials.” See Form 990, Part IX, Line 18. In its 2008 and 2009 Form 990 filings, ALEC did not disclose that it paid for state lawmakers’ travel expenses. Instead, for both years, ALEC left line 18 blank, implying that the organization did not pay for lawmakers’ travel or entertainment expenses during those two years. Ex. 20 at 10; Ex. 21 at 10.

Information obtained through public records requests reveals a different story. Between 2006 and 2008, ALEC spent $1,811,905, an average of roughly $600,000 per year, on state lawmakers’ trips. Ex. 19, at 3-4. Over three hundred state lawmakers per year have received travel funding from ALEC, and more than 1,300 travel subsidy checks from ALEC were cashed in just a three-year period from 2006 to 2008. \textit{Id.} at 4, 13. In fact, during that three-year period, at least twenty state lawmakers received travel funding worth nearly $7,000. \textit{Id.} at 3, 13. In South Carolina, where state legislators received the most from the ALEC Scholarship Fund during this three-year period, state legislators received $200,566 in corporate-funded travel through ALEC. \textit{Id.} at 13.
For the past two years, ALEC completed line 18, Part IX of Form 990, but the organization grossly underreported the extent of its travel funding operation. In 2010, ALEC claimed that it spent only $49,499 on lawmakers’ travel expenditures, see Ex. 22 at 10, and, in 2011, the organization claimed that it spent $125,722 on lawmakers’ travel, see Ex. 23 at 11. Complete public data regarding ALEC’s travel spending is not available for years 2010, 2011, and 2012. However, information obtained through records requests revealed that, in 2010, ALEC spent at least $90,413 on travel for Arizona lawmakers alone. See Ex. 19, Appendix 2. Based on spending data from previous years, it is estimated that, in 2011, ALEC spent roughly $600,000 on travel expenses for state legislators, though the actual spending figure may be significantly higher because ALEC added five hundred members following the 2010 mid-term elections. Id. Ultimately, the $49,999 and $125,722 figures reported on line 18 pale in comparison to ALEC’s actual spending on public officials’ travel.

b. ALEC Misrepresented the Scholarship Funds as Liabilities and Used This Deceptive Reporting Tactic to Conceal Its Funding of Lawmakers’ Travel

ALEC has consistently reported to the IRS that its scholarship funds constitute a liability, and this deceptive reporting tactic has enabled the organization to conceal its extensive funding of lawmakers’ travel. In ALEC’s 2008 Form 990, the organization listed a liability of $1,053,457, which it described as “SCHOLARSHIP FUNDS HELD AS AGENT.” Ex. 20 at 20. In its 2009 Form 990, ALEC listed a liability of $1,042,629, which it also described as “Scholarship funds held as agent.” Ex. 21 at 21.

In its 2010 and 2011 Form 990s, ALEC revised its reporting method slightly and listed these scholarship funds as an escrow or custodial account liability. See Ex. 22 at 11; Ex. 23 at 12. Additionally, ALEC informed the IRS that the scholarship funds should not be treated as the...
organization’s revenue or expenses. See Ex. 22 at 24; Ex. 23 at 28. In ALEC’s 2011 Form 990, for example, the organization provided the following explanation regarding ALEC’s scholarships: “ALEC is the recipient of funds from various outside organizations and individuals which are to be used exclusively for scholarships on behalf of State Legislators. Scholarships are payable, upon approval by the relevant State Chair, to State Legislators to reimburse them for travel expenses incurred attending meetings of ALEC. The amounts received and disbursed by ALEC for such purposes are not considered revenue and expenses of ALEC as ALEC does not select the individuals and the State Chair retains the exclusive right to determine the expenditures.” Ex. 23 at 28-29. A similarly worded explanation was provided in ALEC’s 2010 Form 990. See Ex. 22 at 24-25.

Contrary to ALEC’s characterization of the scholarship funds on its 2008, 2009, 2010, and 2011 Form 990s, these funds are not an ALEC liability. According to paragraph 17 of the Statement of Financial Accounting Standards No. 136 (“FAS 136”), a transfer of assets to a non-profit organization must be accounted for as a liability by the organization if one or more of the following conditions applies:

- “The transfer is subject to the resource provider’s [i.e., the donor company’s] unilateral right to redirect the use of the assets to another beneficiary”;
- “The transfer is accompanied by the resource provider’s conditional promise to give or is otherwise revocable or repayable”;
- “The resource provider controls the recipient organization and specifies an unaffiliated beneficiary”; or
- “The resource provider specifies itself or its affiliate as the beneficiary and the transfer is not an equity transaction.”
The corporate contributions to ALEC’s scholarship fund satisfy none of these criteria. Although the organization’s corporate donors were solicited to underwrite lawmakers’ travel, branded as “scholarships,” their checks were written to ALEC. These corporate donors did not retain a unilateral right to redirect the funds elsewhere; did not make a conditional promise to give or make their donations otherwise revocable or repayable; did not “control” ALEC; and did not specify themselves or their affiliates as beneficiaries of the scholarship fund. In fact, ALEC’s corporate donors did not specify a beneficiary at all when providing their donation to ALEC. Instead, corporate donors contributed to a particular project, namely ALEC’s scholarship fund. This is reflected in correspondence between an ALEC member’s legislative aide and an ALEC staff member. See, e.g., Ex. 24 at 1 (noting that a lobbyist from Eli Lilly was donating $1,000 to ALEC’s “scholarship fundraiser”); Ex. 25 at 1 (requesting that “an invoice for $10,000 for ALEC Ohio,” e.g. ALEC Ohio’s scholarship fund, be sent to a lobbyist from Time Warner Cable).

Moreover, FAS 136 states that contributions to a particular project or field are more appropriately characterized as purpose-restricted contributions, rather than as liabilities. According to paragraph 75 of FAS 136, where a non-profit (e.g., ALEC) makes representations to donors “when accepting gifts, such as representations to use assets in a particular program or to buy a fixed asset,” these representations constitute donor-imposed restrictions. FAS 136, ¶ 75. Assets transferred according to donor-imposed restrictions qualify as purpose-restricted contributions, and they differ from assets transferred to specific beneficiaries, which qualify as liabilities. See id. As FAS 136 explains, a donor-imposed restriction creates a fiduciary responsibility and “a not-for-profit organization’s fiduciary responsibility to use assets to provide services to beneficiaries does not itself create a duty of the organization to pay cash, transfer
other assets, or provide services to one or more creditors.” *Id.* (citing Concepts Statement 6, ¶ 57). By contrast, if a donor identifies a particular beneficiary to which assets must be transferred, that circumstance distinguishes “the transaction from time- and purpose-restricted contributions and makes the recipient organization’s representation to the donor one that constitutes a present obligation of the recipient organization to another entity,” thus creating a liability. FAS 136, ¶ 75.

Corporate donors who give to the ALEC Scholarship Fund are providing purpose-restricted contributions. These corporations are giving money to ALEC for it to be used for a particular purpose, namely to fund state lawmakers’ travel, and ALEC also represents to donors that their contributions will be used for that purpose. As noted above, corporate donors do not identify particular beneficiaries when they give to the ALEC Scholarship Fund. Thus, any donations to this fund should be treated as purpose-restricted contributions, rather than liabilities.

Nor does ALEC act as a mere “agent” for the funds, as it reported on its 2008 and 2009 Form 990s. Again, FAS 136 is instructive. An organization acts as an agent for a donor where “it receives assets from the donor and agrees to use those assets on behalf of or transfer those assets, the return on investment of those assets, or both to a specified beneficiary.” FAS 136, ¶ 10 (emphasis added). As discussed above, in making contributions, ALEC’s corporate donors did not specify a beneficiary, but rather specified the project to which the funds should be allocated. ALEC itself determined the specific beneficiaries to receive the money. Therefore, ALEC does not qualify as an agent according to the definition outlined in FAS 136, since it did not receive and agree to use assets designated for a particular beneficiary.

Moreover, apart from FAS 136, ALEC’s substantial control over the scholarship funds belies any claim that ALEC treats these funds as assets of a third party over which ALEC lacks
control. Although ALEC maintains to the IRS that it holds the scholarship funds in trust and is merely the “recipient of funds from various outside organizations and individuals,” Ex. 23, at 28, ALEC is actively involved in raising and overseeing the distribution of these funds. According to its bylaws from 2007, ALEC’s National Chairman selects the organization’s “State Chairmen,” state legislators who fundraise for scholarship funds, among other functions.¹ ALEC’s bylaws stipulate that the State Chairs’ “duties shall include . . . working with the Private Enterprise State Chairman to raise and oversee expenditures of legislative scholarship funds.”² Additionally, the bylaws dictate where the funds must be deposited: “All funds for ALEC State Scholarship Accounts shall be deposited in accounts designated by the ALEC Board of Directors.”³ Far from passively acting as an agent over the scholarship funds, ALEC is inextricably involved in this scholarship scheme. ALEC contemplated this scholarship funding operation within its own bylaws and has instituted a system for fundraising and overseeing the payment of legislators’ travel expenses.

Moreover, contrary to ALEC’s explanations in its 2010 and 2011 Form 990s, the organization’s State Chairs do not hold exclusive decision-making authority regarding the expenditure of the scholarship funds. ALEC’s bylaws task its State Chairs to work in conjunction with Private Enterprise State Chairmen to fundraise and oversee the expenditure of these funds. In several Form 990 filings, ALEC has even indicated that scholarship fundraising is a collaborative project between State Chairs and ALEC members: “Membership provides assistance to ALEC State Chairs in raising state scholarship funds.” Ex. 20 at 2; Ex. 21 at 2; Ex.

² Id.
³ Id.
22 at 2. Far from holding exclusive decision-making authority, these State Chairs are acting on behalf of ALEC and working alongside ALEC’s private sector leaders and membership.

ALEC’s bylaws and Scholarship Policy demonstrate that ALEC remains in control over these scholarship funds. As noted above, ALEC’s bylaws specify that the scholarship funds must be deposited in accounts designated by the ALEC board. The bylaws also stipulate that “State Chairmen are prohibited from establishing, maintaining, or utilizing any other such accounts for ALEC purposes,” and violation of this provision constitutes grounds for removal from a leadership position and dismissal from ALEC membership.4 Despite the organization’s contention in its IRS filings that the State Chair holds the exclusive right to control the expenditures of the scholarship fund, the record reveals that ALEC does not endow its State Chairs with such authority. ALEC’s bylaws merely provide State Chairs with the authority to “oversee expenditures of legislative scholarship funds.”5 Additionally, under ALEC’s Scholarship Policy, ALEC’s Director of Membership is ultimately responsible for determining the allocation of the scholarship funds: legislators submit travel receipts to their State Chair, and the State Chair must then submit a signed request for repayment to ALEC’s Director of Membership. See Ex. 4. Contrary to its representations to the IRS, ALEC is critically involved in and exercises near total control over this scholarship scheme.

c. While ALEC Represented to the IRS That the Scholarship Funds Are a Liability, It Told Corporate Donors That Their Gifts to the Fund Were Tax-Deductible

If, contrary to the foregoing circumstances, ALEC held the scholarship funds in “trust” for its corporate donors, ALEC would be responsible for encouraging those donors to commit tax

5 Id. (emphasis added).
fraud. Despite the statements on ALEC’s Form 990s that these funds do not belong to ALEC, ALEC leaders have told corporate backers that they can claim a tax deduction for their scholarship fund contributions. Of course, if the contributions are not intended for ALEC itself, there are no grounds for ALEC’s corporate contributors to claim a deduction for the donations. This is yet another basis upon which the IRS should refuse to accept ALEC’s representation that it does not own or control the scholarship funds.

For example, Representative Joseph A. Harrison, an ALEC board member and legislative co-chair for Louisiana, circulated letters on government letterhead, soliciting $1,000 checks from corporations to fund Louisiana lawmakers’ trips. In soliciting these gifts, Harrison emphasized ALEC’s 501(c)(3) status and listed ALEC’s tax ID number, the implication being that a contribution to the scholarship fund would be tax-deductible: “ALEC is a 501(c)(3) nonprofit educational organization as designated by the IRS. Their tax ID number is 52-0140979.” Ex. 26 to the Supplemental Submission, at 1. An IRS filing by the Pharmaceutical Research and Manufacturers of America (PhRMA) confirms that donors have heeded this message and treated their contributions as tax-deductible. PhRMA, a 501(c)(6) trade association, reported in its 2010 IRS filing that it gave $356,075 to the “ALEC Scholarship Fund.” This IRS filing noted that ALEC is a 501(c)(3) organization and listed ALEC’s tax ID number, 52-0140979. It is likely that many corporations have similarly treated their contributions to the scholarship fund as tax-deductible.

ALEC cannot maintain that the scholarship fund contributions are held in trust with ALEC acting as a mere “agent,” yet encourage donors to treat their contributions to the fund as tax-deductible. If ALEC were merely acting as an agent and holding these funds in trust, as

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ALEC has stated to the IRS, then corporate backers would not have any basis to claim a tax deduction for these gifts. Indeed, if these funds were truly liabilities for ALEC, then the funds should be recorded as assets, not as tax-deductible contributions, in corporate backers’ tax filings. Ultimately, ALEC has taken advantage of its 501(c)(3) status to incentivize corporate donations to the scholarship fund and then used deceptive reporting tactics to conceal the extent of its funding of lawmakers’ travel.

ALEC failed to include information regarding its scholarship program that should have been reported on its Form 990s, and the organization also filed incorrect information about this program. As discussed above, in its 2008 and 2009 Form 990s, ALEC did not disclose its payments of lawmakers’ travel despite the fact that Form 990 requires organizations to list this information on line 18, Part IX of the document. Moreover, in 2010 and 2011, ALEC submitted incorrect information regarding the extent of its travel funding, significantly underreporting these expenses on line 18. In numerous tax returns, ALEC misrepresented to the IRS that these scholarship funds were liabilities. Accordingly, ALEC should be subject to civil penalties under Section 6652 of the Internal Revenue Code for filing multiple incomplete and incorrect tax returns.

d. ALEC Also Funds State Lawmakers’ Travel Through a Task Force Scholarship Program

In addition to the ALEC scholarships described above, ALEC operates a separate Task Force scholarship program that covers travel to ALEC’s Spring Task Force Summit for legislators who are members of one of ALEC’s eight task forces. The funds for these legislative scholarships are raised from the private sector members of the task forces, who pay into a task force operating budget, which is used to fund legislators’ travel expenses and hotel rooms.
According to ALEC’s “Task Force Operating Procedures,” each task force operating budget is paid entirely by the “private sector” corporate members of the task force. Ex. 7. Legislative members of ALEC task forces are reimbursed from the task force budget for their travel expenses to certain ALEC meetings, particularly the annual ALEC Spring Task Force Summit. See Ex. 27 at 1. Corporations pay between $2,500 and $10,000 for a seat on a task force where the private sector has an equal vote with state legislators, who pay nothing extra to be on a task force.

ALEC acknowledges in internal documents that the organization itself is directly funding these task force scholarships. For example, an internal document entitled “Reimbursement Policy by Meeting” states that: “ALEC Task Force Members are reimbursed by ALEC up to a predetermined set limit for travel expenses,” and that their “room & tax fees for a two-night stay are covered by ALEC.” Id. (emphasis in original).

ALEC’s spending on these Task Force scholarships must be disclosed as payments for public officials’ travel expenses in its Form 990 filings. As noted above, ALEC disclosed zero dollars on public officials’ travel expenses in its 2008 and 2009 filings, but disclosed some spending in its 2011 and 2012 filings. It is our suspicion that the reported spending in 2011 and 2012 is from ALEC’s Task Force scholarship program and that spending on public officials’ travel expenses from ALEC’s state scholarship program has not been disclosed.

II. ALEC’S SCHOLARSHIP SCHEME CONFERS PRIVATE BENEFITS UPON STATE LAWMAKERS AND ALEC’S CORPORATE MEMBERS IN CONTRAVENTION OF THE ORGANIZATION’S 501(C)(3) STATUS

In addition to the violations outlined above, ALEC’s scholarship scheme confers substantial private benefits upon state lawmakers and corporate donors, thereby disqualifying ALEC from its 501(c)(3) tax-exempt status. In order to be a 501(c)(3) tax-exempt organization,
“an organization must be both organized and operated exclusively” for educational, charitable, or other exempt purposes. Treas. Reg. § 1.501(c)(3)-1(a)(1). The Treasury Regulations establish that an “organization is not organized or operated exclusively” for these purposes “unless it serves a public rather than a private interest.” Id. § 1.501(c)(3)-1(d)(1)(ii). Accordingly, the IRS and courts have consistently determined that an organization’s tax-exempt status should be revoked, where the organization serves a private interest and confers non-incidental private benefits. See, e.g., KJ’s Fund Raisers v. Comm’n, T.C. Memo 1997-424, aff’d, 166 F.3d 1200 (2d Cir. 1998); Am. Campaign Acad. v. Comm’r, 92 T.C. 1053, 1078 (1989); Columbia Park & Recreation Ass’n v. Comm’r, 88 T.C. 1, 25 (1987); Rev. Rul. 76-206, 1976-1 C.B. 154.

Here, ALEC serves a private rather than a public interest. ALEC’s scholarship scheme enables state legislators to receive all-expense-paid family vacations at luxury hotel resorts. In promoting its meetings, ALEC has described these conferences in vacation-like terms, encouraging legislators to “come and experience endless sandy beaches, sunny days, beautiful sunsets and the cool gulf breezes.” Ex. 19 at 14. Additionally, ALEC has actively encouraged legislators to bring their families, even offering subsidized childcare, which it calls “Kids Congress.” Id. Not only does ALEC subsidize lawmakers’ travel, but ALEC’s corporate donors also wine and dine state lawmakers at the conferences, typically sponsoring recreational events like golf lessons, exclusive parties at Major League Baseball games, dinners at expensive restaurants, and other entertainment. Id. at 15. For state legislators, who nationally earn an average of $35,000 per year, funding for just one trip confers a substantial private benefit upon lawmakers. Id. at 14. Since “scholarships” appear to range between $500 and $2,500 per
legislator, ALEC legislative members can easily receive funding equivalent to a significant percentage of their salaries by attending just two or three ALEC meetings a year.\footnote{See http://www.prwatch.org/news/2012/03/11342/why-did-phrma-spend-356k-alec-wisconsin.}

Besides conferring a private benefit upon state lawmakers, this scheme also confers a private benefit upon the corporations who funnel money into ALEC’s scholarship fund. Over one hundred corporations have funded lawmakers’ trips to ALEC meetings. Besides PhRMA, which gave $356,075 to the scholarship fund in 2010, other major corporate donors include: AT&T, Bayer, Eli Lilly, UST Public Affairs, Pfizer, Crown Cork & Seal, Altria, Verizon, and Blue Cross Blue Shield Association. Ex. 19 at 3.

The scholarship scheme enables these corporations and their lobbyists to have direct contact with lawmakers and to ensure that their agenda is codified into law. Indeed, ALEC’s Private Sector Membership brochure touts that “[o]ne of ALEC’s greatest strengths is the public-private partnership. ALEC provides the private sector with an unparalleled opportunity to have its voice heard, and its perspective appreciated, by the legislative members.” Ex. 28 at 1. Likewise, an ALEC advertisement promises that “[t]he format of the meetings provides the ideal climate for private sector-legislator communication. For four days, ALEC private sector members have the opportunity to share their thoughts and opinions on the crucial public policy issues facing their organizations.” Ex. 19 at 23. A thank you letter written by Representative John Adams, the ALEC State Chair in Ohio, attests to the fact that corporate members’ scholarship fund contributions often sway legislators to push through “business friendly” legislation: “Because of your help and others like you, the trip to ALEC was made possible for our legislators. . . . With information that is disseminated at [ALEC] meetings, my desire is that
the Ohio Legislature will pass and repeal laws to make Ohio a much more business friendly state.” Ex. 29 at 1.

Ultimately, ALEC’s scholarship fund activity provides private benefits to two core constituents: 1) state legislators, who receive all-expense-paid vacations and 2) corporate donors, who are able to obtain “business friendly” legislation through this influence peddling. ALEC provides more than incidental private benefits to state lawmakers and corporations, and hence the organization is not operated exclusively for exempt purposes. The IRS should revoke ALEC’s 501(c)(3) status on these grounds.

CONCLUSION

The materials referenced in this letter, and in Common Cause’s Original Submission and Supplemental Submission to the IRS, show that ALEC massively underreported its lobbying activities and grossly misrepresented its scholarship scheme to the IRS. Moreover, the materials demonstrate that ALEC operated for substantial nonexempt purposes, as the organization engaged in an impermissible amount of lobbying and served private rather than public interests. Therefore, we respectfully request that the IRS conduct an immediate investigation, impose necessary civil and criminal penalties, and collect unpaid taxes for work done that is inconsistent with ALEC’s tax-exempt status.

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