

IRS should clarify that the selective placement of issue ads in states or districts where close elections are taking place is a negative factor in the analysis of nonpartisanship.

In another fact pattern, a section 501(c)(4) entity that advocates for better health care takes out a full-page ad in several newspapers in a state shortly before an election in which one of the state's senators is seeking reelection. The ad is not part of an ongoing series of substantially similar advocacy communications by the group on the same issue. The ad says federal assistance is needed to build a public hospital in a major city in the state and points out that in the past year the senator has voted for bills that would have provided the funding for the hospital. It asks readers to let the senator know if they agree with the need for federal funding of hospitals. A Senate bill has been introduced that would provide the funding, but no vote or other major legislative activity on the bill is scheduled.

The Service noted that the ad identifies the senator, appears shortly before an election in which the senator is a candidate, and targets voters. The ad indicates that the senator's position on the hospital funding issue is consistent with the organization's position, and the ad is not part of an ongoing series of substantially similar advocacy communications by the group on the same issue. Moreover, the ad does not identify specific legislation and is not timed to coincide with a vote on a bill or other major legislative action on the hospital funding issue. Thus, the amount spent on the ad is an exempt function expenditure under section 527(e)(2) and is subject to tax under section 527(f)(1).

Elizabeth Kingsley of Harmon, Curran, Spielberg & Eisenberg LLP, Washington, called Rev. Rul. 2004-6 a good piece of work. "It's tremendously useful," she told Tax Analysts. Although it doesn't address all section 527 taxable activities, it does deal with practices that many advocacy groups will be engaging in, she said. She also praised the revenue ruling for covering gray areas, not just good and bad facts.

"I'm not sure I agree with the outcome in some areas," Kingsley said. "But at least we now know what they're thinking, and they've really shown us how to get there. I think this helps organizations know they can engage in protected speech without uncertainty about the tax implications." ■

Full Text Citations

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YEAR IN REVIEW

A Fast and Furious Year on Capitol Hill

By Patti Mohr — patriciam@tax.org

The 108th Congress made significant tax changes in 2003, setting the stage for a new year full of presidential debates about the economy. Changes included a 15 percent tax rate on dividends and capital gains through 2008, marginal income rate reductions, a \$100,000 expensing limit for small business expenses, a 50 percent bonus depreciation allowance, "marriage penalty" relief, an increase in the alternative minimum tax exemption for individuals and married couples, a \$1,000 child credit, a series of tax relief measures directed at members of the military, and a new tax-preferred vehicle to allow individuals to save for health care expenses. Altogether the changes will provide more than \$335 billion in tax relief in the near term.

But those changes didn't come easily for the Republican caucus, which experienced rifts that threatened the party's unity. Republicans faced internal challenges from the moment they took control of both chambers. Senate Republicans started the year by selecting a new leader to replace Trent Lott, R-Miss., after he had made racially insensitive remarks at a televised birthday party for the late Sen. Strom Thurmond, Second-term Sen. Bill Frist, R-Tenn., took Lott's place as majority leader. It took Frist several months to settle into the position.

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House Democrats also selected a new leader when House Minority Leader Richard Gephardt, D-Mo., stepped down. The party overwhelmingly chose Rep. Nancy Pelosi, D-Calif., to take charge. Pelosi managed to unify the diverse party into a force that aggressively challenged the controlling party's policies and procedures.

Moving an Agenda

Republicans moved their agenda with force throughout the year. They paused only to quell party infighting, persuade defectors to vote with the party, or deal with the public's questions about leaders who might have overstepped their authority in controlling the chamber.

Tax cuts were the focus early in the year.

President Bush dispatched his new Treasury secretary, John Snow, to Capitol Hill to sell the administration's \$726 billion tax cut package. Snow spent long days in members' offices and in committees talking to lawmakers who didn't think eliminating taxes on dividends was practical given the budget outlook. Snow and his team of Treasury officials never gave up. They carried on with such determination that they eventually persuaded the Senate to adopt the dividend tax elimination.

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The accomplishment was significant considering the battle that preceded it. The House and Senate were at odds over the amount they should set aside in a special budgetary procedure for tax cuts. The House conceded that Bush's \$726 billion tax package could be trimmed to \$550 billion. But a core group of Senate centrists that included Senate taxwriter Olympia Snowe, R-Maine, and George V. Voinovich, R-Ohio, insisted they could support only \$350 billion in a new stimulus package. The standoff led to a budget battle that almost ended in disaster but instead provided a tricky twist that made the rest of the tax cut process more interesting.

House GOP leaders and budget writers convinced themselves that Snowe and Voinovich wouldn't dare vote against a Republican budget, even if it included a \$550 billion tax cut reconciliation package. House leaders signed a deal on a conference report with Frist and Senate Budget Committee Chair Don Nickles, R-Okla., and moved it directly to the House floor.

The House predawn 216-211 vote on the budget conference report put the Senate in an uncomfortable position. Senate leaders knew they lacked the 51 votes to pass the report and knew they could not amend the report to win the two additional votes they needed to pass it. Senate Republicans did not welcome press inquiries during that period of uncertainty and said only that they were still working on securing the votes.

Few people knew about events that occurred between the time the House took up the budget conference report and the next day when the Senate followed suit. The Senate leadership's solution to the problem became clear only when Finance Committee Chair Charles E. Grassley, R-

Iowa, discussed it on the Senate floor. As Grassley explained it, he secured Voinovich's vote for the budget by promising the senator that his concerns would be addressed during tax cut negotiations. Grassley said he would not return from a House-Senate conference with a tax reconciliation package that exceeded the centrist's \$350 billion marker.

The news traveled fast. It infuriated House GOP leaders who thought they had won the House-Senate standoff. House Speaker J. Dennis Hastert, R-Ill., was seen in the hallways of the Capitol boiling with rage. He later declared the House would stick to its \$550 billion tax cut despite the Senate's inability to "get its house in order." House Majority Leader Tom DeLay, R-Texas, and House Budget Committee Chair Jim Nussle, R-Iowa, held an impromptu press conference to denounce the "secret side deal" shortly after Grassley's floor speech. DeLay declared that the House would deliver a tax package that would "stimulate more than some senator's ego."

Grassley became the man for House Republicans and their allies to hate. Voinovich and Snowe became targets for the Club for Growth, a pro-tax-cut political action committee that launched an advertising campaign against the senators in their home states. The ads compared Voinovich and Snowe to French opponents of the war in Iraq.

The newly appointed Frist also took a hit from his House counterparts. Frist apologized for his "error" of not informing House leaders about the deal Grassley made with Voinovich. It took several months for Frist to recover from the fall.

The 'Creative' Thomas

Meanwhile, House Ways and Means Committee Chair William M. Thomas, R-Calif., got to work on the \$550 billion House tax cut. He held numerous hearings to examine the "ripple" effects the dividend exclusion would have on other tax breaks, and in the end determined that Bush's exclusion was not feasible. Interest groups insisted that the exclusion would make their tax break less valuable because taxpayers would have had to calculate the shareholders' excludable dividend amount (EDA). Thomas's plan eliminated Treasury's provisions that would have required corporations to calculate the EDA, the retained earnings basis adjustments, or the cumulative retained earnings basis adjustments.

Thomas came up with an alternative that would cut the capital gains tax to 15 percent and trim taxes on dividends to match it. He included all the other features of Bush's plan, added a 50 percent bonus depreciation for businesses and AMT relief for individuals, and trimmed the cost

by making all the tax cuts temporary. The package contained no offsets or revenue-raisers. DeLay praised the work of the “creative” Ways and Means chair, saying it pleased the conservative caucus and was a “targeted tax cut with a really big target.”

House Democrats offered their own \$136 billion stimulus plan early in the year. Ways and Means Committee ranking minority member Charles B. Rangel, D-N.Y., opted against offering the package as an alternative during the committee’s markup, but supported other Democrats who offered a series of amendments proposing to strip out the \$277 billion dividends-capital gains tax reductions, extend unemployment benefits, raise the AMT exemption, and provide a payroll tax holiday.

Rangel’s decision to not offer an alternative during the committee markup made it difficult for Democrats to offer one during floor consideration. Republican leaders refused to allow the chamber to vote on the alternative, arguing that Democrats had not allowed the tax committee to review it in advance. The House Rules Committee approved a closed rule, which limited debate to one hour and forbade Democrats from offering their alternative. Democrats were able to discuss their alternative only during a procedural motion to send the bill back to committee.

Senate Offsets

The Senate took its turn at designing creative tax laws. Senate taxwriters drafted an alternative to Bush’s dividend exclusion that made heads spin. The \$85 billion proposal would exclude the first \$500 of dividend income from taxable income, phase in an additional 10 percent of dividend income exempted from tax from 2004 through 2008, and increase that additional amount to 20 percent during the second half of the decade.

Nickles later achieved a short-lived victory during Senate floor consideration. The Senate replaced the committee formula with a three-year plan to provide Bush’s full dividend exclusion.

Most of the attention from the Senate taxwriters’ markup focused on the proposals to offset the cost of tax cuts and state aid in excess of \$350 billion. The Finance Committee markup sent lobbyists scrambling to their cell phones in the hallways of the Hart Senate Office Building. Lobbyists were overheard apologizing to their clients who would have benefited from the \$71 billion in tax breaks Senate taxwriters were proposing to repeal.

Grassley added more offsets during the markup process to accommodate a moving plea

by Senate taxwriter Blanche L. Lincoln, D-Ark., to expand the refundable child tax credit for the benefit of low-income working families. Lincoln voted to clear the bill from the committee, making the markup “bipartisan,” but the move to expand the refundable child credit would later come back to haunt Republicans.

Senate taxwriters also sifted through many of the 150 amendments offered to the mark and dealt with issues such as the tax treatment of annuities, a plan to allow companies to repatriate foreign earnings, a tax deferral on U.S. property investments in Puerto Rico, and state aid proposals.

The Tax Chairs Meet

Grassley and Thomas met privately to reconcile the differences between their bills. Although both chambers had officially appointed additional conferees, the two chairs told them to sit the conference out.

The biggest issue Grassley and Thomas had to settle was the conflict over their plans to cut the dividend tax. House members doubted the Senate’s three-year exclusion would create a single tax structure. Senate backers of the exclusion and the Bush administration argued that a dividend tax cut would not effectively reform the code unless it provided a full exclusion.

Thomas ultimately won out during a late-night negotiating session with Grassley and then taunted a reporter the next day who had concluded that the Senate position would prevail. Thomas also made one last-ditch effort to include more tax cuts in the plan. He positioned for \$350 billion in tax cuts and \$30 billion in state aid, rather than a \$350 billion total tax cut and state aid package.

No one was completely satisfied with the final compromise, especially Democrats, who had little to say throughout the process.

Vice President Dick Cheney helped broker the deal, ensuring that it could pass both chambers. The result was a conference report that included all the features of the House bill, reduced the cost of the tax cut to \$330 billion by further shortening the effective dates, excluded all the Senate offsets, and stripped the Senate expansion of the refundable child tax credit. No one was completely satisfied with the final compromise, especially Democrats, who had little to say throughout the process.

Congress approved the plan by the target Memorial Day deadline, and Bush signed it into

law soon at a ceremony attended by Frist and Thomas.

Beware: Children at Rally

Just when everyone thought there was no more to say about the 2003 tax cut, a series of news reports in *The New York Times* told them otherwise. The paper reported that Thomas and Grassley had overlooked eight million low-income workers with children who would not receive child credit checks in the mail. Liberal think tanks also reported that the number of taxpayers left out included 5.6 million taxpayers who pay more than \$250 in income tax.

A White House spokesman initially dismissed the issue, but later changed his tune when Bush embraced the expansion of the refundable credit and told Republicans on Capitol Hill to get it done.

The attention forced House Republicans into an uncomfortable position of supporting refundable tax cuts for people who don't have income tax liability.

Democrats rallied for the refundable child credit and never gave up efforts to put it on the congressional agenda. Pelosi organized a grass-roots effort that seemed to grow by the day. She helped organize several rallies on Capitol Hill, including one in which women pushing baby carriages delivered mock "child credit checks" to DeLay's office.

Senate taxwriters quickly drafted a \$10 billion bill offset with an extension of Customs user fees to provide a refundable credit for working families and cleared it through the chamber.

All the attention forced House Republicans into an uncomfortable position of supporting refundable tax cuts for people who don't have income tax liability — a position conservatives have opposed in the past. Thomas soon invented a way out of the mounting political distress. He drafted a "solution" that allowed House Republicans to vote for an expansion of the refundable credit, but it was packaged in a much larger bill doomed to go nowhere.

Democrats fought for the refundable child credit for the rest of the year. They offered weekly procedural motions to force House Republicans to continually vote against a Senate-passed simple extension of the refundable credit and forced Senate Republicans to routinely reconsider the plan.

The firestorm over the child credit eventually died down. Although Democrats' uproar over the issue persisted, it became clear that a House-Senate conference on the child credit would never begin.

A Summer Heat Wave

The summer doldrums started to set in during July — but not for long. Thomas created pandemonium that reached far beyond the Ways and Means Committee's walls and gave every observer something to remember about the summer of 2003.

As if Ways and Means markups aren't theatrical enough, Thomas added extra drama to a July markup of a pension bill. He was disturbed that Democrats had left the markup to meet in a committee room Republicans typically use and directed his staff to have the Capitol Hill police eject the Democrats. Thomas declared that the minority party can delay the majority's will but cannot obstruct it. He rushed through the proceedings of the pension bill, overriding the objections of House taxwriter Fortney Pete Stark, D-Calif., with a quick chairman's gavel.

Meanwhile, Stark and House taxwriter Scott McInnis, R-Colo., engaged in a derogatory exchange and called each other names like "old man" and "fruitcake." Reporters got pulled into the mix when Democrats who were still meeting in the committee conference room invited reporters to take a bird's-eye view of the affair as it unraveled. The Capitol Hill police showed up, but wanted nothing to do with the committee conflict.

Thomas stopped short of apologizing for his actions but acknowledged that he made a 'poor judgment' call.

Pelosi later led Democrats in a revolt on the House floor. They offered a resolution condemning Thomas's actions and the "abuse of power" of House Republicans as a whole.

Thomas dodged the press for days. When House GOP leaders urged him to address the matter, he delivered a tearful speech on the House floor. He stopped short of apologizing for his actions but acknowledged that he made a "poor judgment" call. House Republican taxwriters rallied behind Thomas throughout the affair and at the end declared that the Ways and Means chair is a "sensitive" man.

The pension bill went nowhere, but the events created an aura of unchecked power that lingered throughout the year.

Marathon Meetings

When Congress returned to work after the August recess, taxwriters got busy with Bush's plans to provide a Medicare prescription drug benefit and an energy bill.

Medicare conferees who participated in the conference met continually in Thomas's office in the Capitol. The group included Thomas, House taxwriter Nancy L. Johnson, R-Conn., House Energy and Commerce Committee Chair W.J. (Billy) Tauzin, R-La., Grassley, Finance Committee ranking minority member Max Baucus, D-Mont., Nickles, and Senate taxwriters John B. Breaux, D-La., and Jon Kyl, R-Ariz. Thomas often gathered the Medicare group at 7:30 a.m. and again during the afternoons.

Although Rangel was officially tapped as a conferee, he said he had not been invited to any of the meetings. Rangel and a group of House Democrats attempted to "crash" the conference one afternoon. They drew attention from the media, but only for a short while. Television crews rushed off to cover breaking news about a "gunman" the Capitol Hill police said was on the loose in a House office building. The gun man turned out to be a House staffer who packed a Halloween costume in her bag on her way back from lunch.

Conflicts between Thomas and Grassley intensified during the autumn. When the two were not meeting on Medicare, they were exchanging paper proposals on a package of energy tax incentives. Thomas refused to discuss any details or general outlines of either bill, and he chastised Grassley for talking to the press. They battled over the energy bill and agreed to a plan only after Cheney proposed some solutions.

In the end, the energy bill included numerous tax breaks. It died during a Senate filibuster led by a coalition of senators opposed to the bill's tax subsidies and liability protections for energy producers. Congress managed to enact a set of major reforms to Medicare after Republican leaders in both chambers persuaded enough members to clear it. House GOP leaders held the 15-minute vote open for three hours to give themselves time to win enough votes. Senate Republicans cleared the conference report only after they were able to persuade Lott to vote against

his convictions in a procedural motion to bring debate to a close.

Reflecting on 2003

All in all, the events of 2003 brought to light the deep divisions within the Republican Party, a caucus that has been known for its order and cohesive stability. In contrast, Democrats showed they could wield a serious challenge to the majority by uniting the diverse members of the caucus.

When Republicans first won control of the House in 1994, they argued that the Democrats controlling the House had abused their authority. Republicans instituted a series of new rules that opened the process up to greater scrutiny and provided for a more competitive system. Democrats now argue that the roles have been reversed. They say Republican leaders regularly abuse the rules and control the House with an arrogance that denies half the public representation in Congress.

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The open system of 1994 does seem to have eroded. But one "revolutionary" doesn't seem to mind. Asked about the polarizing events of the past year, former House Speaker Newt Gingrich, R-Ga., said House Republicans can't afford to open the process up until they win a much larger majority.

"I think we have the problem right now that as long as Nancy Pelosi can keep the Democrats as unified as she has — which is a real achievement on her part — the countervailing strategy has to be to try to win every vote by a very narrow margin," Gingrich said. "When you have a very, very close majority, if you can't find a way to get a bipartisan vote you end up with very, very tight rules because you can't afford to lose. You define the majority by winning." ■