



FEDERAL ELECTION COMMISSION  
WASHINGTON, D.C. 20463

April 9, 2012

**MEMORANDUM**

**TO:** Thomas Hintermister  
Assistant Staff Director

**FROM:** Christopher Hughey *pch*  
Deputy General Counsel

Lawrence L. Calvert, Jr. *[Signature]*  
Associate General Counsel

Lorenzo Holloway *[Signature]*  
Assistant General Counsel  
For Public Finance and Audit Advice

Danita C. Lee *[Signature]*  
Attorney

**SUBJECT:** Draft Final Audit Report – Minnesota Democratic-Farmer-Labor Party  
(LRA 835)

**I. INTRODUCTION**

The Office of the General Counsel has reviewed the Draft Final Audit Report (“DFAR”) on the Minnesota Democratic-Farmer-Labor Party (“MDFLP” or “Committee”). Our comments address issues pertaining to the MDFLP’s payroll account as presented in Finding 1 (Misstatement of Financial Activity) and Finding 2 (Overfunding of Federal Accounts by Non-Federal Accounts). We concur with any findings not specifically discussed in this memorandum. If you have any questions, please contact Danita C. Lee, the attorney assigned to this audit.

As background, the MDFLP claims that it established a separate payroll account to ease its administrative payroll processing burden. MDFLP Federal and non-Federal operating accounts transferred funds into the payroll account. The MDFLP made Federal and non-Federal payroll disbursements for salary and taxes from the payroll account. The MDFLP did not allocate the salaries of any of its employees but rather paid employee salaries as either 100% Federal or 100% non-Federal. The MDFLP did not disclose any non-Federal activity associated with the payroll account. The MDFLP states that the payroll account “was intended to act solely as a ‘pass through’ account and was

not intended to pay any expenses other than the payroll expenses for which other [Committee] accounts would remit sufficient funds to pay those expenses." The MDFLP, therefore, concluded that it was not required to disclose any non-Federal activity.

## **II. USE OF PAYROLL ACCOUNT (Findings 1 and 2)**

### **A. Effect of the Georgia Federal Elections Committee Audit Is Unclear**

Finding 1 addresses the MDFLP's failure to disclose non-Federal activity associated with the payroll account. The DFAR concludes that the payroll account is a Federal account from which all activity, including non-Federal activity, is reportable to the Commission. The Commission considered similar facts when it addressed the Audit Division Recommendation Memorandum on the Georgia Federal Elections Committee ("Georgia Committee"). In the Georgia Committee audit, the Commission considered the permissibility of a payroll escrow account and whether the Georgia Committee was required to disclose non-Federal activity associated with the payroll escrow account. The Georgia Committee had established a separate account from which to make its Federal and non-Federal payroll disbursements. The Georgia Committee transferred funds from its Federal and non-Federal operating accounts to a payroll account to enable its payroll vendor to pay the salaries of the committee's Federal, non-Federal, and allocable employees. The Georgia Committee considered the payroll account an "escrow account" because the account was used exclusively by its payroll vendor to draw funds to pay salaries and payroll taxes. The Georgia Committee asserted that the payroll escrow account was neither a Federal account nor an allocation account, and thus, stated that it was not required to report the account's non-Federal activity. The Commission concluded that the Georgia Committee was "not required to further amend its reports in relation to the transactions involving the payroll escrow account." Audit Division Recommendation Memorandum on the Georgia Federal Elections Committee, Motion #4 on A07-14 (Georgia FEC) ("Consensus" Motion) v.2.

The language of the motion approved by the Commission in the Georgia Committee audit, however, did not state the reasons for the Commission's conclusion, and different Commissioners advanced different rationales – some of them more than one rationale. Accordingly, we are unsure whether the payroll account in this case is legally distinguishable from the payroll escrow account used by the Georgia Committee. Given the uncertainty in how the Georgia Committee audit should be interpreted, we suggest that the Audit Division raise this issue with the Commission in the Audit Division Recommendation Memorandum.

In the Georgia Committee audit, a majority of Commissioners did not accept the argument we set forth in our legal analysis memorandum that the payroll escrow account there was the "functional equivalent" of an allocation account established pursuant to 11 C.F.R. § 106.7(f), and that all of the account's activity was, therefore, reportable under 11 C.F.R. § 104.17(b).

During the June 2010 audit hearing, Commissioner McGahn stated that the Commission had previously seen the type of payroll escrow account used by the Georgia Committee and had not disapproved of its use or required additional reporting. Commissioner Peterson noted that the regulations do not prohibit payroll escrow accounts.<sup>1</sup>

If the conclusion reached by the Commission in the Georgia Committee audit was that the committee's payroll escrow account was neither a Federal nor a non-Federal account and its non-Federal funds did not require disclosure, we are unable to perceive a legally significant difference between the account there and the account here. Similar to the account in the Georgia Committee audit, the account here appears to have been set up as a type of escrow account used only for the payment of salary and payroll taxes. It does not appear to have been any more of an allocation account than the account that the Georgia Committee established. It is true, as the Audit Division pointed out, that the account in the Georgia Committee audit was established to accommodate a payroll processing vendor that represented it could not handle payroll from multiple bank accounts for a single client, whereas this account was administered by the Committee itself and appears to have been established solely for the Committee's administrative convenience. But the written conclusion in the Georgia Committee audit was not limited by the facts regarding the payroll vendor. If the Commission's action in the Georgia Committee audit means that committees conducting both Federal and non-Federal activity may establish "payroll escrow" accounts of this type that are neither Federal nor non-Federal, and that any 100% non-Federal payroll that flows through this account need not be reported, we do not see that the committee's motive for establishing such an account makes any difference.

On the other hand, if the Commission's action in the Georgia Committee audit was an act of administrative discretion driven by the fact that there was no "overfunding" of Federal or allocable payroll in that case, the Commission should be aware that somewhat different facts are present here.<sup>2</sup>

In our comments after the Georgia Committee audit hearing, we noted that

[I]n the circumstances where the Commission has permitted the mixing of federal and non-federal money in the same account, committees have been required to disclose all of the activity in that account, including the non-

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<sup>1</sup> In addition to these two Commissioners who indicated disagreement with our analysis during the audit hearing, Commissioner Weintraub, during subsequent Commission consideration of the Audit Division Recommendation Memorandum, said that she was not comfortable concluding either that the payroll escrow account was an allocation account or determining that the Georgia Committee had complied with the law. She noted that payroll escrow accounts were not contemplated by the regulations.

<sup>2</sup> We understand the auditors use the term "overfunding" to refer to net subsidization of a Committee's Federal account by its non-Federal account, and "underfunding" to refer to the reverse, that is, net subsidization of a Committee's non-Federal account by its Federal account.

federal portion. See 11 C.F.R. § 104.17(b) . . . The purpose of these requirements is to "allow the Commission to track the flow of non-federal funds into federal accounts," and "ensure that the use of such funds is strictly limited to payment for the non-federal share of allocable activities." Explanation and Justification for Methods of Allocation Between Federal and Nonfederal Accounts, 55 Fed. Reg. 26,058, 26,065-66 (June 26, 1990).

Memorandum to Joseph F. Stoltz, July 1, 2010, at 3.

We noted that the Commission might wish to determine that because the Audit Division was satisfied that non-Federal funds in the Georgia payroll account had been strictly limited to payment of 100% non-Federal salaries and taxes and the non-Federal share of allocable salaries and taxes, then, as a matter of administrative discretion, there was no need to require the Georgia Committee to amend its reports to disclose 100% non-Federal payroll.

Several Commissioners noted the lack of overfunding at various points in the Commission's consideration of the Georgia Committee audit. During the audit oral hearing, Commissioner Walther indicated that he did not have any concerns with the Georgia Committee's payroll account because there was no overfunding present. Commissioner McGahn indicated that since there was no evidence of circumvention involving non-Federal money funding Federal activity and because the auditors confirmed there was no overfunding, he considered the Georgia Committee's payroll account permissible. Commissioner McGahn also distinguished "pass-through" accounts from accounts where there is a potential of soft money flowing into Federal accounts and funding Federal activity. Finally, at the Commission meeting on the Audit Division Recommendation Memorandum, Commissioner Weintraub noted that she believed the Georgia Committee did not need to make any additional disclosures, in part, because the Georgia Committee's payroll account transactions did not involve any non-Federal subsidization of Federal activity.<sup>3</sup>

Somewhat different facts, however, are at issue here. In the Georgia Committee audit, there was neither any net overfunding of the Committee's activities as a whole, nor was there any overfunding of the Federal share of salaries and payroll taxes. New information provided by the MDFLP in response to the Interim Audit Report establishes that, as in the Georgia Committee audit, there was no net overfunding of the MDFLP's activities as a whole. However, unlike in the Georgia Committee audit, here there was overfunding of the payroll account, in the amount of \$102,663 over the course of the election cycle. The DFAR, however, ultimately finds that overall the MDFLP

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<sup>3</sup> Commissioner Weintraub also noted that the committee in that matter had come using the payroll account and had come into literal compliance with the regulations. The Committee here is in the same position.

“sufficiently demonstrated that it did not overfund its Federal accounts with funds from its non-Federal accounts.”<sup>4</sup>

If the outcome of the Georgia Committee audit was merely an act of administrative discretion based on the lack of overfunding in that case, then the Commission might decide to exercise its discretion similarly in this case given the overall lack of net overfunding; or alternatively, it might not decide to exercise its discretion similarly given that the payroll account here *was* overfunded, and the reporting of all disbursements from accounts with mixed Federal and non-Federal funds is designed both to prevent and to identify precisely such overfunding.

By clarifying the rationale for its action in the Georgia Committee audit – and, if that rationale was based solely on an exercise of administrative discretion, determining clearly whether to extend that discretion to the facts here – the Commission can resolve the issue in this case. The Audit Division can assist the Commission by raising the issue in the Audit Division Recommendation Memorandum, and by specifically noting that here the payroll account was overfunded, but that because of other transactions there was overall no net overfunding by the non-Federal account.

**B. Comments on the Committee’s Assertion of an Historical Basis  
Establishing Permissibility of the Payroll Account**

The Committee stated that it “believed that this [payroll] account was established sometime during the 1970’s and [that it] has been used ever since to facilitate payroll payments which have been handled in-house by the [Committee].” The Committee said that it “believed in good faith, that the 100% non-Federal payroll expenses need not be disclosed on Federal reports” despite the “Commission’s implementation of its allocation regulations in 1991 (former 11 C.F.R. § 106.5) and the passage of the Bipartisan Campaign Reform Act of 2002.”

The Commission audited the MDFLP for the 1988, 1990 and 1992 election cycles. None of the Final Audit Reports for these audits addressed the payroll issue present here.

We would not have expected the issue to have arisen in the 1988 and 1990 cycle audits. Prior to the 1992 election cycle, committees that chose to establish both Federal and non-Federal accounts were absolutely prohibited from transferring non-Federal funds

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<sup>4</sup> The DFAR concludes that, in addition to the \$102,663 in overfunding of the payroll account, the Committee used \$8,833 in non-Federal funds to fund 100% Federal activity, and did not report this activity. It also concludes that the Committee effectively used Federal funds to subsidize the permissible non-Federal share of allocable activities in the amount of \$120,960 over the course of the election cycle. A Committee may, of course, always choose to use Federal funds to meet non-Federal obligations. Subtracting the amount of overfunding from the amount of underfunding, the DFAR concludes that on an overall net basis over the course of the election cycle, the Committee’s Federal account effectively subsidized \$9,464 of non-Federal activity.

into the Federal account; thus, allocable expenses were paid either with two checks or by transferring funds representing the Federal share *out* of their Federal accounts, and making the payments from their non-Federal accounts.

The 1992 allocation regulations changed the procedures for payment of allocable expenses. Under the new regulation, committees were for the first time permitted to transfer in non-Federal funds, in a limited fashion and under strict restrictions, for the payment of the non-Federal share of allocable expenses; they were now required to pay allocable expenses from the Federal account, to report on Schedule H2 transfers in to cover non-Federal shares, and to report specific allocated disbursements – including the Federal and non-Federal shares of each – on Schedule H4.

The 1992 cycle audit of the Committee noted the existence of the payroll account, and noted that the Committee had, during the 1992 cycle, impermissibly followed the pre-1992 process by transferring a lump sum of Federal funds to the payroll account representing the Federal share of *allocable* salaries, and reporting simply that lump sum transfer on Schedule B. The Final Audit Report concluded that the Committee should have itemized each individual *allocated* salary payment to each individual employee on Schedule H4.

However, the Final Audit Report did not address the issue of 100% non-Federal salary that is presented here. There are a number of possible reasons for this omission. First, it is possible that the Committee simply did not have any 100% non-Federal payroll in the 1992 cycle. Second, it is possible, given the reference to the Committee's continuing to follow the pre-1992 process, that the Audit Division regarded the payroll account as a *non-federal* account, with the payment of allocable payroll from that account contrary to the procedures established in the new regulations. Third, it is possible that the Audit Division did not regard the non-reporting of 100% non-Federal payroll as a violation, which would support the Committee's position here. Fourth, it is possible that any problematic unreported disbursements did not meet materiality thresholds for inclusion in the report. Because there is no remaining information indicating which of these possibilities occurred in the Committee's 1992 cycle audit, there is no basis for saying whether the determinations made in that audit should inform this one.

### **III. HEALTH AND RETIREMENT BENEFITS EXPENSES PAID FROM FEDERAL ACCOUNT (Finding 1)**

Although the MDFLP paid its employee salaries and taxes from its payroll account, the MDFLP paid from a Federal "administrative" account employee health insurance and retirement benefits for both its 100% Federal and 100% non-Federal employees. The MDFLP initially did not report either the transfers in or transfers out associated with the 100% non-Federal benefits costs.

At the Interim Audit Report stage, we concurred with the Audit Division that the failure to report this activity comprised part of the misstatement of the Committee's

financial activity. However, we also noted that, in our view, the transfer in of these funds and the use of the Federal account to pay these 100% non-Federal disbursements might have violated 11 C.F.R. § 106.7(f). The regulations provide that "State, district and local party committees may transfer funds from their non-Federal to their Federal accounts or to an allocation account *solely* to meet *allocable* expenses under this section[.]" 11 C.F.R. § 106.7(f) (emphasis added). An expense payable with 100% non-Federal funds is, by definition, not allocable, and thus transfers of non-Federal funds to a Federal account and payment of the expense thereafter by the Federal account are not permissible. 11 C.F.R. § 106.7(f). Based on the way the Committee had reported the benefits payments for the 100% Federal employees, and on its non-reporting of benefits payments for the 100% non-Federal employees, we raised the possibility that the Committee had intended to pay these expenses using the same procedures as are required for allocable expenses, but as if they were "allocated" 0% Federal and 100% non-Federal. This, in our view, would not be consistent with 11 C.F.R. § 106.7(f).

The DFAR indicates that the Committee has now amended its reports to disclose on Schedule H4 payments to its benefits providers that are reported as allocated between a Federal share, representing the portion of the payment associated with 100% Federal employee compensation, and a non-Federal share, representing the portion of the payment associated with 100% non-Federal employee compensation. This would indicate that the Committee's checks or transfers to its benefits providers actually did contain a mix of Federal and non-Federal funds, rather than any of the payments being 100% non-Federal but paid using the same methods as an allocated expense. Assuming this is consistent with the auditors' understanding of the Committee's payment practices, we would see no reason to pursue the issue regarding 11 C.F.R. § 106.7(f).