CONFERENCE NOTES

Disaster Relief Activities of Charitable Organizations

*by Catherine E. Livingston**
Caplin & Drysdale

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Panel on Disaster Relief Activities
of Charitable Organizations

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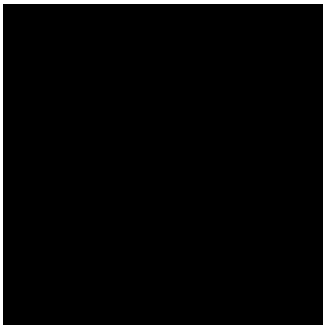

Catherine E. Livingston

The federal tax law requirements applicable to IRC section 501(c)(3) organizations providing disaster relief are well-developed with respect to some issues and less clear with respect to others. Below you will find discussion of the issues and existing authorities that address them drawn from legislative materials, regulations, published and unpublished rulings, IRS publications and training materials, and cases.

Disaster Relief as a Charitable Activity

For purposes of section 501(c)(3), the term "charitable" is defined to include "relief of the poor and distressed or of the underprivileged. . . ." See Treas. reg. section 1.501(c)(3)-1(d)(2). The recently released text of a special IRS publication on disaster relief makes clear that relieving distress caused by a disaster fits squarely within this definition. The publication states that "providing aid to relieve human suffering that may be caused by a natural or civil disaster or an emergency hardship is charity in its most basic form." *Disaster Relief: Providing Assistance Through Charitable Organizations* (*Advanced Text of Special IRS Publication*), available at http://www.irs.gov/relief/aid-charity-pub.pdf (the Special Publication) at 1. [Reprinted in *The Exempt Organization Tax Review*, October 2001, p. 98; *Doc 2001-24029 (9 original pages)*; and 2001 TNT 182-18.] The Special Publication echoes the view the IRS expressed in training materials issued to exempt organizations examiners in September of 1999. In an article titled *Disaster Relief and Emergency Hardship Programs* authored by Ruth Rivera Huetter and Marvin Friedlander, the IRS made clear that disaster relief was an entirely appropriate charitable activity provided that the organization conducting the activity was directing its efforts toward a charitable class and conducting its activities so as to avoid inurement or impermissible private benefit.

At least one published ruling addresses relief of distress suffered by survivors of an individual killed in hazardous circumstances. Rev. Rul. 55-406, 1955-1 C.B. 73, holds that an organization formed to provide gifts of cash and property to widows and orphans of firefighters and police officers who die in the line of duty qualifies for exemption as an organization described in section 501(c)(3). It should be noted that the IRS has published one notice subsequent to September 11, 2001 regarding the deductibility of contributions to leave-based donation programs. See Notice 2001-69 2001-46, I.R.B. 491 (Oct. 25, 2001) [*Doc 2001-26961 (3 original pages, 2001 TNT 207-5*].

Charitable Class

In order to further charitable purposes, disaster relief must be directed to a charitable class of beneficiaries. The IRS has emphasized this point in its Special Publication (page 4) and in its 1999 training materials. To form a charitable class, a group of persons must either be so large that the interests of the class merge with the interests of the community as a whole, or the class must be indefinite. The option of having a very large class is consistent with the reasoning in Rev. Rul. 67-325, 1967-2 C.B. 113, which states that "[i]n that general body of law [on the definition of charity], certain purposes have been deemed to be beneficial to the community as a whole even though the class or classes of possible beneficiaries eligible to receive a direct benefit from the dedication of property to the particular purpose do not include all the members of the community." The option of having an indefinite class is reflected in the reasoning of a Supreme Court decision upholding the validity of a charitable trust:

> By the law of England from before the statute of 43 Eliz. C 4 and by the law of this country at the present day . . . trusts for public charitable purposes are upheld under circumstances where private trusts would fail. . . . They may, and indeed must, be for the benefit of an indefinite number of persons; for if all the beneficiaries are personally designated, the trust lacks the essential element of indefiniteness, which is one characteristic of a legal charity.

See *Russell v. Allen*, 107 U.S. 163, 167 (1882).

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The indefinite class option is also illustrated in Rev. Rul. 56-403, 1956-2 C.B. 307, which holds that an organization awarding scholarships to members of all chapters of a designated fraternity may qualify as an organization described in section 501(c)(3). Although the class of beneficiaries is limited, no specific beneficiaries are named, and the purposes for awarding the scholarships are not "personal, private, or selfish in nature."

A small group of identified individuals is not a charitable class. Therefore, providing relief exclusively to such a group, even if they are suffering to a great degree, is not a charitable activity within the meaning of section 501(c)(3). See Rev. Rul. 67-367, 1967-2 C.B. 188, describing an organization that does not qualify for exemption under section 501(c)(3) because it awards scholarships exclusively to specifically named individuals selected by subscribers who contribute money to fund the scholarships. See also *W.L. Parker Rehabilitation Foundation*, 52 T.C.M. 51, T.C. Memo 1986-348 (exemption denied to organization that conferred substantial benefits on a child of the founder).

Relevance of Financial Need for Assistance

The regulations define a charitable purpose as "relief of the poor and distressed or the underprivileged." The regulations do not address the question of whether recipients of the relief must demonstrate financial need. The Special Publication states that the charity must have "a set of criteria by which it can objectively make distributions to individuals who are financially *or otherwise* distressed." Special Publication at 4 (emphasis added). Following the bombing of the federal building in Oklahoma City, the IRS provided a general information letter to charity officials in the city that outlined its basic views on the law of tax-exempt organizations and disaster relief. It states quite clearly that "[p]ersons may qualify as distressed even if they would not otherwise have qualified as poor." Letter from Richard Hanson, Internal Revenue Agent, to Jon H. Trudgeon (Aug. 25, 1995) (the Oklahoma City Letter) at 2. However, it then says, "[t]he fact that even persons of wealth may be appropriate objects of relief efforts does not relieve an organization of the burden of justifying its distributions to individuals." The letter also says that "an outright transfer of funds based solely on an individual's involvement in a disaster or without regard to meeting the individual's particular distress or financial needs would result in excessive private benefit." Oklahoma City Letter at 9.

With respect to organizations providing relief to victims of the September 11 disasters, section 104 of the Victims of Terrorism Tax Relief Act of 2001 specifically provides as follows:

> Payments made by an organization described in section 501(c)(3) . . . by reason of the death, injury, wounding, or illness of an individual incurred as the result of the terrorist attacks against the United States on September 11, 2001, or an attack involving anthrax occurring on or after September 11, 2001, and before January 1, 2002 shall be treated as related to the purpose or function constituting the basis for such organization's exemption under section 501 of such code if such payments are made in good faith using a reasonable and objective formula which is consistently applied.

Given the particular sensitivities associated with the relief efforts for victims of the September 11 disasters, and cognizant of the pending legislation, the IRS issued Notice 2001-78 on November 19, 2001. [See *The Exempt Organization Tax Review*, December 2001, p. 428; *Doc 2001-28892 (1 original page)*; or *2001 TNT 223-6*.] It states that the Service will treat payments made by charities to individuals and their families as related to the charity's exempt purpose provided that the payments are made in good faith using objective standards. Given that the Notice states it will remain in effect until the earlier of final legislative action addressing the issues or December 31, 2002, the statutory provision from the Victims Relief Act appears to supersede the Notice.

It should be noted that section 104 of the Victims of Terrorism Tax Relief Act applies only to disaster relief activities directed to victims of the September 11 disasters and not to victims of any other disaster. The legislative history accompanying the Act included a general discussion of disaster assistance provided by charitable organizations outside the September 11 context and included the following commentary on the needs of victims:

> Generally speaking, a charitable organization must serve a public rather than a private interest. Providing assistance to relieve distress for individuals suffering the effects of a disaster generally serves a public rather than a private interest if the assistance benefits the community as a whole, or if the recipients otherwise lack the resources to meet their physical, mental and emotional needs. Such assistance could include cash grants to provide for food, clothing, housing, medical care, funeral costs, transportation, education and other needs. All such grants must be need-based, taking into account the family's financial resources and their physical, mental, and emotional well-being.

Joint Committee on Taxation, *Technical Explanation of the "Victims of Terrorism Tax Relief Act of 2001,"* as Passed by the House and the Senate on December 20, 2001 (JCX-93-01), December 21, 2001, at 17. [See *Doc 2001-31590 (36 original pages)* or *2001 TNT 247-10*.]

Documentation

If a public charity is accomplishing its charitable purposes by making grants to individuals, it must maintain records with respect to each grant. The IRS stated its position on this point in Rev. Rul. 56-304, 1956-2 C.B. 306, which holds that an organization may make grants to individuals and be operated for charitable purposes within the meaning of section 501(c)(3) provided that it maintains records to show the name and address of each recipient, the amount distributed to each, the purpose for which the aid was given, the manner in which the recipient was selected, and any relationship between the recipient and managers of or major contributors to the organization.

The Oklahoma City Letter indicates that only minimal records are necessary when providing short-term assistance

immediately after a disaster. For longer-term relief, complete and accurate documentation showing the applicant's financial condition should be collected. See Oklahoma City Letter at 2-3. The letter states that the records should show the names and addresses of aid recipients, the amount of type of aid given to each, the purpose for which the aid was given, the manner in which the recipients were selected, and the relationship, if any, between recipients and officers or directors or key employees.

Documentation is equally important for private foundations making grants to individuals. All such grants must be listed each year in Section XV of Form 990-PF. Furthermore, grants to individuals for travel, study, or similar purposes constitute taxable expenditures under section 4945(d)(3) unless the foundation has received an advance ruling approving its procedures for awarding the grants. Acceptable procedures must include a procedure for obtaining and reviewing reports from the grantees. See Treas. reg. section 53.4945-4(c)(1)(iii).

Employer-Sponsored Charities Assisting Employees

Employer-sponsored charities must be sensitive to any benefits they provide exclusively to employees of the sponsor to be certain they are (a) not violating the prohibition in section 501(c)(3) against inurement, and (b) complying with the operational test, which requires that they not be operated to any substantial degree for the benefit of private interests. See Treas. reg. section 1.501(c)(3)-1(d)(1)(ii).

What guidance there is on this subject addresses employer-sponsored foundations providing scholarships to employees and their family members. The decision in *Copperweld Steel Company's Warren Employee's Trust v. Commissioner*, T.C. Memo. 1991-7 (Jan. 14, 1991), held that a trust providing scholarships to employees of a particular company that funded the trust and their family members did not qualify for exemption as an organization described in section 501(c)(3). The trust awarded scholarships only to employees and their family members. It did not review the academic credentials or financial need of the applicants. The program was found to further a substantial nonexempt purpose, namely to provide a compensatory fringe benefit to the company that funded the trust.

Treas. reg. section 53.4945-4(b)(5), *Example 1*, describes a foundation organized by Company X that awards scholarships to children of Company X employees. Two thousand applications are typically received, and 100 scholarships are awarded each year. Selection is made by a committee of educators who have no relationship to Company X. Selection is based on academic performance, aptitude, and financial need. The example concludes that the Foundation is operated in accordance with the requirements of section 501(c)(3).

Rev. Rul. 81-217, 1981-2 C.B. 217, describes two private foundations that make grants to fund scholarships for the children of employees. One foundation requires that its grants be used exclusively for this purpose. The other permits its grants to be used for scholarships for non-employee children, after all finalists who are employee children have been funded. In both cases, the ruling holds that the grant programs are subject to the guidelines for employer-related grants contained in Rev. Proc. 76-47, 1976-2 C.B. 670.

Rev. Proc. 76-47 establishes guidelines for employer-funded private foundations making scholarship or fellowship grants for the benefit of employees. The revenue procedure states its purpose as follows:

> The purpose of this Revenue Procedure is to provide guidelines to be used in determining whether a grant made by a private foundation under an employer-related grant program to an employee or to a child of an employee of the particular employer to which the program relates is a scholarship or fellowship grant subject to the provisions of section 117(a) of the Code. . . .
>
> The guidelines are directed only to the foregoing question of qualification under section 117 of the Code. For example, they are not directed to whether the private foundation's employer-related grant program meets the rules of section 53.4945-4(b) of the regulations requiring that the foundation's program be consistent with its exempt status and the allowance of deductions to individuals under section 170 for contributions to the foundation and that the group from which grantees are selected is a "charitable class." The guidelines *assume that those requirements have been met* except insofar as that conclusion may be affected by the failure of the educational grants to be scholarships or fellowships subject to the provisions of section 117(a) and the reason for such failure. (emphasis added)

The assumption stated above allows for the legal possibility that an employer-funded foundation can award grants on an objective and nondiscriminatory basis to a charitable class of beneficiaries where the beneficiary class is initially limited to employees and their family members. The guidelines are intended to evaluate whether the scholarships are awarded on a basis that falls "outside the pattern of employment" so as to counter the presumption that the employer is providing the grants as a form of compensation.

Although there is no published guidance on the specific subject of employer-sponsored foundations offering disaster relief to employees, the IRS has offered a window onto its thinking through unpublished rulings. In 1995, the IRS issued two private letter rulings (PLRs 9516047 and 9544023) with respect to an employer-funded private foundation that sought to offer temporary financial assistance to employees adversely affected by natural disasters. [For PLR 9516047, see *95 TNT 79-61*; for PLR 9544023, see *95 TNT 219-52*.] In the first ruling, disqualified persons were not eligible to receive assistance. (A disqualified person is defined in section 4946 as including any officer or director of a private foundation as well as their family members and any entities in which they have a profits or voting interest of 35 percent or more.) Employees who were victims of declared federal, state, or local disasters, such as fires, floods, hurricanes, and acts of war would be eligible for assistance from the program. Local coordinators were empowered to issue small grants after gathering minimal information to pay for food, clothing, temporary housing, and other immediate needs. A grant re-

view committee composed of employees who were not senior managers of the company scrutinized applications for additional relief from those with particularly severe losses. Grants were made strictly on a finding of financial hardship. The maximum grant available was $5,000. The second ruling involved a program that made grants up to a maximum of $25,000 available for hardship suffered because of natural disasters or other emergencies. Grants could be used for housing, furniture, clothing, automobiles, medical expenses, and the like, but not to cover losses of luxury items like jewelry or boats. Selection committees reviewed applications for assistance on a blind basis. In the first ruling, the IRS concluded that the establishment of the program furthered charitable purposes. In the second, it concluded that payments made under the program would not be taxable expenditures and would not be acts of self-dealing.

In 1999, the IRS revoked the two favorable 1995 rulings. In PLR 199914040, which revoked the first ruling, the IRS states that the employee assistance program gives the employer and its subsidiaries a significant benefit because "potential employees will consider the advantages of such a program while employees will find it an enhancement to financial security and incentive to continue employment." PLR 199917077 which revoked the second ruling, offers the same reason for finding the program in conflict with the requirements of section 501(c)(3). [For PLR 199914040, see *The Exempt Organization Tax Review*, June 1999, p. 526; *Doc 1999-13370 (16 original pages)*; or *1999 TNT 69-57*. For PLR 199917077, see *Doc 1999-15667 (14 original pages)* or *1999 TNT 84-70*.]

The revocation of the two 1995 letter rulings created significant uncertainty as to whether an employer-sponsored foundation could direct assistance specifically to employees and their survivors who were victims of disasters. The Special Publication lists 10 criteria to be weighed in determining whether employment is "merely a factor rather than the sole basis for providing relief." The Special Publication suggests that if employment is merely a qualifying factor, but otherwise not a relevant criteria in making awards, and the assistance is awarded based on consistent objective criteria by a committee that is not a proxy for management, then the assistance program may pass muster. The legislative history accompanying the Victims of Terrorism Tax Relief Act provides the following comments from Congress on these private letter rulings and the question generally of employer-sponsored charities engaged in disaster relief activities for the benefit of employees:

> If payments in connection with a qualified disaster are made by a private foundation to employees (and their family members) of an employer that controls the foundation, the presumption that the charity acts consistently with the requirements of section 501(c)(3) applies if the class of beneficiaries is large or indefinite and if recipients are selected based on an objective determination of need by an independent committee of the private foundation, a majority of the members of which are persons other than persons who are in a position to exercise substantial influence over the affairs of the controlling employer (determined under principles similar to those in effect under section 4958). The presumption does not apply to grants made to, or for the benefit of, a disqualified person or member of the selection committee. However, the absence of an independent selection committee does not necessarily mean that a foundation violates the requirements of section 501(c)(3). Other procedures and standards may be adequate substitutes to ensure that any benefit to the employer is incidental and tenuous. Similarly, providing need-based payments to employees and their survivors in response to a disaster other than a qualified disaster may well further charitable purposes consistent with the requirements of section 501(c)(3).
>
> It is intended that an employer-controlled private foundation is not providing an inappropriate benefit and is not disqualified from exemption under section 501(c)(3) if it makes a payment to an employee or a family member of an employee (who is employed by an employer who controls the foundation) that relieves distress caused by a qualified disaster as defined under section 139, provided that it awards grants based on an objective determination of need using either an independent selection committee or adequate substitute procedures, as described above. It is further intended that section 102(c) of the code, which provides that a transfer from an employer to, or for the benefit of, an employee generally is not excludable from income as a gift, does not apply to such payments. It is further expected that the Service will reconsider the ruling position it has taken to ensure that private foundations established and controlled by employers will have appropriate guidance, consistent with the principles outlined above, on the circumstances under which they may provide disaster assistance in connection with a qualified disaster specifically to the employers' employees.

Joint Committee on Taxation, *Technical Explanation* at 18. The next step in the development of the law in this area will presumably be published guidance from the IRS.

Assistance to Businesses, Rather Than Individuals

There is no existing guidance directly ruling that section 501(c)(3) organizations may make grants or loans to businesses as a means of accomplishing their charitable purposes. The closest existing authority are the regulations under section 4944 which describe program-related investments that a private foundation may make without making a jeopardizing investment. See Treas. reg. section 53.4944-3. Criteria for program-related investments include the ability to demonstrate that the investment furthers charitable purposes, and the examples include loans to and equity investments in for-profit businesses. The ABA Tax Section's 9/11 Task Force made a submission to the IRS and Treasury analyzing this question and providing a positive resolution. A copy of the submission is attached to this memorandum. [For the initial submission, see *The Exempt Organization Tax Review*, December 2001, p. 428; *Doc 2001-26395 (4 original pages)*; or *2001 TNT 201-21*.] A subsequent submission was forwarded to the IRS in response to an inquiry from IRS and Treasury

attorneys asking for specific examples of grants or loans charities were interested in making. The additional submission is also attached. [For the supplemental submission, see *Doc 2002-933 (2 original pages)* or *2002 TNT 8-19*.]

The Oklahoma City Letter takes a very restrictive view. It says that "a business is not an appropriate charitable beneficiary." It goes on to say the business can be helped only if the charity can determine that the owner is having difficulty meeting basic needs, and helping the business is an indirect way of helping the owner. See Oklahoma City Letter at 12-13. The letter says that if employees of the business are suffering hardship, they can be helped with charitable grants, but providing a grant to the business to meet payroll would not serve charitable purposes.

Special Issues for Private Foundations Providing Disaster Relief Directly to Victims

Private foundations are subject to certain additional requirements under chapter 42 of the code that do not apply to public charities. For private foundations engaged in disaster relief activities, two of these requirements are of particular relevance: the ban on self-dealing, and the ban on taxable expenditures.

If a private foundation makes a disaster relief grant to a disqualified person with respect to the foundation, the foundation faces a serious risk of engaging in an act of self-dealing. Furnishing goods, services, or property to a disqualified person is one of the categories of self-dealing identified in section 4941(d)(1). Disqualified persons include directors and officers and their family members.

Under section 4945(d)(3), scholarships and other payments to support study are taxable expenditures unless the foundation awarding them has received an advance ruling approving its objective procedures for selecting recipients and monitoring the use of the payments. See section 4945(g); Treas. reg. section 53.4945-4. Some private foundations may be interested in providing scholarships or similar payments to disaster victims and their survivors. Accordingly, they will need to obtain an IRS ruling before making any such payments. If the foundation is being newly incorporated, the request for the advance ruling can be made as part of the application for tax-exempt status.

Income Tax Treatment of Charitable Assistance Payments

Under section 102, gifts are excludible from income. The IRS has recognized that payments made by a charitable organization based on financial need for exclusively charitable purposes are excludible from income as gifts. See Rev. Rul. 99-44, 1999-2 C.B. 549 [*Doc 1999-33179 (8 original pages)* or *1999 TNT 199-5*]. The ruling specifically addresses matching payments made by charities to beneficiaries of individual developments accounts, but the principle, as stated, appears to have broader application. The ruling is cited in the Joint Committee technical explanation for the Victims of Terrorism Tax Relief Act as illustrating the broader principle.

The Victims of Terrorism Tax Relief Act enacted a new IRC section 139 which excludes qualified disaster relief payments from income. Such payments include amounts paid to an individual to reimburse or pay reasonable living expenses for housing, food, clothing, transportation, medical care, and funeral expenses. Payments must be made on account of a presidentially declared disaster, one triggered by terrorism or military action, or one declared under state or local law. There is no dollar limit on the amount that can be excluded under this provision, and there is no restriction on who may be the payor. Thus, to the extent section 102 does not provide complete comfort to charities making payments to victims of qualified disasters, section 139 provides specific assurance that the payments are excludible from income.

Under section 102(c), payments made from an employer to an employee are not excludible from income as gifts. However, as the Joint Committee technical explanation again confirms, this provision does not apply where an employer transfers funds to a section 501(c)(3) organization which then has discretion over distributions to any individuals who are employees of the donor employer.

For those victims who may be receiving disaster assistance from governmental sources as well as private charities, the general welfare doctrine may be relevant. This doctrine, which has been articulated in several published IRS rulings but not in any statutory provisions or cases, treats as excludable from income certain amounts paid by a federal, state, or local government entity as relief to an individual who has suffered distress or injustice. Rev. Rul. 76-144, 1976-1 C.B. 17, holds that a recipient has no income as a result of receiving a grant funded under section 408 of the Disaster Relief Act of 1974. The ruling states that "disbursements from a general welfare fund in the interest of the general welfare are not includible in gross income." Rev. Rul. 74-74, 1974-1 C.B. 18, holds that awards made to crime victims by the Crime Victims Compensation Board of the State of New York are not includible in income. In the facts of that ruling, awards are made to those who suffer physical injury as a result of a crime and experience out-of-pocket financial losses as a result.

September 11 Victims Compensation Fund of 2001 — Charitable Contributions Not Treated as Offsets

The September 11 Victim Compensation Fund of 2001 was created by Title IV of the Air Transportation Safety and System Stabilization Act. See Public Law 107-42, 115 Stat. U.S. 230. The law authorizes a Special Master, appointed by the U.S. Attorney General, to review claims from victims and survivors and award compensation based on the extent of the harm to the claimant, including economic and noneconomic losses, and the amount of compensation to which the claimant is entitled based on the claim and the individual circumstances of the claimant. See section 405(b)(1)(B). The statute directs the Special Master to reduce the amount of compensation determined by the amount of collateral source compensation. See section 405(b)(6). Collateral sources are defined to include "all collateral sources, including life insurance, pension funds, death benefit programs, and payments by federal, state, or local governments related to the terrorist-related aircraft crashes of September 11, 2001." See section 402(4). The Special Master solicited comments in advance of issuing proposed regulations interpreting the statute.

On December 21, 2001, the Special Master issued interim final regulations. They provide that charitable contributions, meaning payments from private charitable organizations to victims, would not be treated as collateral source compensation and, therefore, would not offset the amount of compensation victims could receive from the September 11 Victim Compensation Fund. However, section 104.47(b) of the regulations provides that collateral source payments do not include "charitable donations distributed to the beneficiaries of the decedent, to the injured claimant, or to the beneficiaries of the injured claimant by private charitable entities; provided, however, that the Special Master may determine that funds provided to victims or their families through a private charitable entity constitute, in substance, a payment [that constitutes collateral source compensation]." It is unclear how this proviso is intended to operate or when the Special Master would use the discretion granted him by the rule.

A number of charitable organizations submitted comments to the Special Master urging him not to treat charitable contributions as collateral source payments. Several of particular interest may include the submissions from the Nonprofit Coordinating Committee of New York, the Council on Foundations, and individual members of the ABA Tax Section's 9/11 Task Force.