

DISASTER RELIEF BY EMPLOYER-CONTROLLED CHARITIES

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Providing aid to victims of civil or natural disasters has historically been a basic function of charitable organizations. Following the terrorist attacks against the United States on September 11, 2001, and the subsequent attacks involving anthrax, numerous charities,¹ including many that had been formed specifically in response to those events, assisted victims through cash grants and the provision of services. The response of the charitable sector raised numerous questions regarding the treatment of disaster-relief assistance under federal tax law. One area of uncertainty was the appropriate treatment of disaster relief provided by private foundations and public charities controlled by an employer, particularly when the employer-controlled charity assists the controlling corporation's employees.²

The Victims of Terrorism Tax Relief Act of 2001 (the "Victims Relief Act"), signed into law on January 23, 2002, authorizes a variety of forms of tax relief for victims of terrorism and other disasters. The Victims Relief Act, the accompanying legislative history, and a recent IRS publication on disaster relief provide guidance to employer-controlled charities that seek to provide assistance to employees who are victims of civil or natural disasters.

TREATMENT OF DISASTER RELIEF BY EMPLOYER-CONTROLLED CHARITIES PRIOR TO THE VICTIMS RELIEF ACT

A charitable organization must be organized and operated to serve public, rather than private, interests in order for the Internal Revenue Service (the "Service") to recognize it as exempt from federal income tax under Code section 501(c)(3) and for donors to be able to claim

¹ As used in this memorandum, the term "charities" refers to organizations exempt from federal income taxation under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code"), and classified as either public charities or private foundations within the meaning of Code section 509(a).

² As used in this memorandum, unless context suggests otherwise, the term "employees" refers to those persons employed by a company that has a company-controlled private foundation or public charity that may assist those persons employed by the affiliated company from time to time.

charitable deductions under Code section 170. An organization formed to benefit a particular individual or a small number of specified individuals will not be recognized as exempt because it does not serve a sufficiently broad “charitable class.” In addition, a private foundation that provides certain benefits to “disqualified persons” will be subject to a “self-dealing” excise tax penalty;³ similar penalties apply to “excess benefit transactions” between a public charity and a disqualified person under the rules known as “intermediate sanctions.”⁴

In two private letter rulings issued in 1995,⁵ the Service addressed disaster-relief programs established by employer-controlled private foundations. In those programs, the foundations provided grants or loans to employees and former employees of the corporations who faced financial hardship following disasters. In one case, the assistance was also extended to employees facing financial hardship for other personal reasons, such as medical emergencies. The assistance programs were administered by committees of the corporations’ employees. Applicants were required to demonstrate financial need in order to receive assistance.

The Service initially ruled favorably on each disaster-relief program, saying that the grants and loans were in furtherance of the foundations’ tax-exempt purposes and would not trigger self-dealing penalties under Code section 4941 or other excise taxes. However, in 1999, the Service reversed its position and revoked these two rulings.⁶ In its revocations, the Service stated that it considered the disaster-relief programs similar to other types of employee-benefit programs that serve the private interests of the employer and its employees, rather than the interests of the broader public. The Service reiterated this change in position in its 1999 Exempt Organizations Continuing Professional Education Technical Instruction Program (the “CPE Text”)⁷, in which it stated that “[b]oth an employer related disaster relief program and an emergency hardship program operated by a private foundation would generally be viewed as providing more than an incidental or tenuous benefit to the employer and, therefore, would be in conflict with the self-dealing, taxable expenditure and qualifying distribution provisions.”

³ See Code section 4941. For these purposes, a “disqualified person” includes a person (including a corporation) who is a substantial contributor to the foundation.

⁴ See Code section 4958.

⁵ Priv. Ltr. Rul. 9516047 (Jan. 23, 1995); Priv. Ltr. Rul. 9544023 (Nov. 3, 1995). A private letter ruling is precedential authority only for the taxpayer who obtained it. Nonetheless, private letter rulings are useful guides to the Service’s views on a particular topic.

⁶ Priv. Ltr. Rul. 199914040 (Apr. 12, 1999); Priv. Ltr. Rul. 199917077 (May 3, 1999).

⁷ The CPE Text is not precedential authority, but is used as an internal training manual for the Service’s auditors and is a useful guide to the Service’s views.

However, with respect to a *public charity* that is related to a particular employer, the CPE Text indicates that if certain conditions are met, the charity may be able to make disaster-relief and hardship payments to employees without being deemed to be serving the private interests of the employer rather than a charitable purpose. The CPE Text lists 14 conditions to be used by its auditors in assessing employer-related disaster-relief and emergency-hardship assistance programs, although it does not indicate whether satisfaction of all 14 conditions is a prerequisite for favorable treatment. Included in the list is the requirement that the employer not “excessively control” the public charity distributing relief. Under this requirement, the employer would be permitted to receive reports about how funds it contributes to the public charity are being used, to provide non-binding advice to the public charity, and to provide administrative services to the public charity at fair market value, provided that the public charity is in charge of making decisions about its investments and programs. The CPE Text does not indicate whether having a board of directors consisting entirely of employees would result in the public charity being “excessively controlled” by the employer.

RECENT DEVELOPMENTS

THE VICTIMS RELIEF ACT AND ACCOMPANYING LEGISLATIVE HISTORY

In response to the attacks of September 11, 2001, Congress passed the Victims Relief Act.⁸ Section 111 of the Victims Relief Act amends the Code by adding new Code section 139, which excludes from gross income any amount received by an individual as a “qualified disaster relief payment.” A “qualified disaster relief payment” includes payments of certain expenses incurred as a result of a “qualified disaster.” A “qualified disaster” is a disaster which results from a terroristic or military action, a Presidentially-declared disaster, a disaster resulting from an accident involving a common carrier or from any other event which is determined by the Secretary of the Treasury to be of a catastrophic nature or, with respect to payments made by a federal, state or local government, a disaster determined by the applicable authority to warrant government assistance.

The legislative history⁹ to Section 111 of the Victims Relief Act also sets forth the following general principles for disaster-relief payments:

⁸ Certain provisions of the Victims Relief Act relating specifically to provision of disaster relief to victims of September 11th are the subject of our November 30, 2001, memorandum entitled “*Disaster-Relief Assistance: The Requirement of Need or Distress in the Context of Charitable Gifts.*” Additional copies of this memorandum are available upon request or at our website, www.simpsonthacher.com.

⁹ Joint Committee on Taxation, *Technical Explanation of the “Victims of Terrorism Relief Act of 2001,” as passed by the House and the Senate on December 20, 2001* (JCX-93-01), December 21, 2001.

Charitable organizations generally are in the best position to determine the type and amount of, and appropriate beneficiaries for, disaster relief. Accordingly, it is expected that the Secretary [of the Treasury] will presume that a charity providing cash assistance *in good faith* to victims (and their family members) of a qualified disaster is acting consistent with the requirements of section 501(c)(3) *if the class of beneficiaries is sufficiently large or indefinite and the charity can demonstrate that it is applying consistent, objective criteria for assessing need.* [Emphasis added.]

These provisions were not, however, included in the Victims Relief Act and were not added to the Code. In fact, new Code section 139, which appears in the Code among other sections dealing with exclusions from gross income, is not in a portion of the Code where one would normally look for provisions directly applicable to charities.

The legislative history goes on to note the uncertainty in the Service's position regarding the treatment of disaster-relief payments made by employer-controlled private foundations to employees, and states that "clarification [by the IRS] of the appropriate treatment of the foundation and the payments may be helpful." The legislative history sets forth the following guidelines for such "clarification":

- An employer-controlled private foundation that makes payments in connection with a qualified disaster to employees (and their family members) will be entitled to the presumption that it is acting consistently with the requirements of Code section 501(c)(3) and is not providing an inappropriate private benefit if:
 - the class of beneficiaries is large or indefinite, and
 - recipients are selected based on an objective determination of need by an independent committee of the foundation, a majority of the members of which are not persons who are in a position to exercise substantial influence over the affairs of the employer (determined under principles similar to those in effect under Code section 4958), or based on "adequate substitute procedures."¹⁰
- Need-based payments from an employer-controlled foundation to individuals for exclusively charitable purposes, including the relief of distress caused by a qualified disaster, are excludable from the recipients' income as gifts, regardless of whether the payments fall within the scope of Code section 139, and regardless of Code

¹⁰ The legislative history does not explain what "adequate substitute procedures" might be, except to note that such procedures would "ensure that any benefit to the employer is incidental and tenuous."

- section 102(c), which provides that a transfer from an employer to an employee generally is not excludable from income as a gift.
- Disaster-relief payments made by a private foundation that support a large or indefinite class of beneficiaries and are granted based on an objective determination of need (and that therefore qualify for the presumption that the foundation is acting consistently with the requirements of Code section 501(c)(3)):
 - will not be treated as an act of self-dealing under Code section 4941 merely because the recipient is an employee (or family member of an employee) of a disqualified person with respect to the foundation;
 - will be treated as in furtherance of the foundation's charitable purposes; and
 - will be considered to meet the requirements of Code section 4945(g) (regarding grants to individuals by private foundations), to the extent that they apply.
 - Contributions to a Code section 501(c)(3) organization administering relief in the manner outlined above (including contributions made by employers and employees) are deductible for federal income-tax purposes under the generally applicable rules of Code section 170.

With respect to the Service's 1999 position on employer-controlled private foundations, the legislative history states:

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.¹¹

IRS PUBLICATION ON DISASTER RELIEF

Following the enactment of the Victims Relief Act, the Service released a revised version of Publication 3833, entitled "Disaster Relief: Providing Assistance through Charitable Organizations" (the "Disaster Relief Publication"). Copies of this publication are available at the "Charities and Non-Profits" section of the Service's website, www.irs.gov.

¹¹ Id.

The Disaster Relief Publication describes the Service's current position, in light of the Victims Relief Act and the language in its legislative history, with respect to disaster-relief payments by employer-controlled charities. The Service addresses "employer-sponsored private foundations" and "employer-sponsored public charities" in separate sections of the Disaster Relief Publication.¹²

Employer-Controlled Private Foundations

The Service's discussion of employer-controlled private foundations is similar to the discussion in the legislative history to the Victims Relief Act. The Service sets forth three requirements that an employer-controlled private foundation must meet in order for the foundation to benefit from the presumption that disaster-relief payments to employees (or their family members) in response to a qualified disaster are consistent with the foundation's charitable purposes:

- the class of beneficiaries must be large or indefinite;
- the recipients must be selected based on an objective determination of need; and
- the selection must be made using either an independent selection committee or adequate substitute procedures to ensure that any benefit to the employer is incidental and tenuous. The selection committee is considered to be independent if a majority of the committee members are persons who are not in a position to exercise substantial influence over the affairs of the employer.

The Service notes that the requirements in the Disaster Relief Publication are consistent with the principles outlined in the legislative history to the Victims Relief Act. The Disaster Relief Publication specifically limits the availability of the favorable presumption to payments made in response to a qualified disaster. The presumption also does not apply to payments that would otherwise constitute self-dealing, such as payments to directors of the foundation or members of the foundation's selection committee. In addition, the Disaster Relief Publication notes that an employer-controlled foundation's program of disaster-relief payments may not be used to induce employees to follow a particular course of action (such as to continue their employment) or to relieve the employer of a legal obligation to provide employee benefits (such as an obligation under a collective bargaining agreement).

¹² Although the Disaster Relief Publication uses the term "employer-sponsored," and the CPE Text uses the term "employer related," the legislative history to the Victims Relief Act uses the term "employer-controlled." For the sake of consistency, this memorandum will continue to use the term "employer-controlled." For further discussion of these differences in terminology, please see the discussion at the conclusion of this memorandum under the caption "Open Issues."

Although the Service has not formally revoked its 1999 rulings, the statements in the Disaster Relief Publication indicate that the Service is not likely to follow its previous private ruling position and that, if the above-described guidelines are followed, an employer-controlled foundation may operate a program that provides disaster-relief payments to employees facing hardship after a qualified disaster.

Employer-Controlled Public Charities

In order to benefit from the presumption that its disaster-relief payments are consistent with its exempt purposes, an employer-controlled public charity must satisfy the same requirements as an employer-controlled private foundation, that is, a large or indefinite class of beneficiaries, an objective determination of need, and a selection process that uses either an independent selection committee or adequate substitute procedures to ensure that any benefit to the employer is incidental and tenuous.

However, the Disaster Relief Publication states that because public charities receive support from a broader base of contributors than private foundations, employer-controlled public charities may provide assistance in response to disasters and emergency hardship situations that are not “qualified disasters.” Therefore, employer-controlled public charities will be presumed to be acting consistently with their charitable purposes in situations where employer-controlled private foundations will not receive the benefit of the presumption – for example, to meet the needs of families facing financial hardship for reasons other than a qualified disaster, such as disasters that do not meet the definition of “qualified disasters,” unusual medical expenses due to a family member’s severe illness or uninsured losses caused by crime. Public charities may also continue to look to the criteria previously set forth in the CPE Text for guidance on how to conduct a disaster relief and emergency hardship assistance program.

OPEN ISSUES

The Victims Relief Act and the Disaster Relief Publication resolved many of the unsettled issues regarding the treatment of disaster-relief assistance payments by employer-controlled charities. However, several questions remain unanswered.

First, to what extent will events that take place outside the United States be considered “qualified disasters?” Many companies have employees in foreign countries, and their affiliated foundations may be interested in extending their disaster-relief programs to those employees. The definition of “qualified disaster” in new Code section 139 includes disasters resulting from terroristic or military action, Presidentially-declared disasters, and events that are determined by the Secretary of the Treasury to be of a “catastrophic nature.” Although a

“terroristic or military action” may occur outside the United States,¹³ a Presidentially-declared disaster relates only to events that occur in the United States.¹⁴ Therefore, other than with respect to terroristic or military actions, the determination that an event outside the United States is a “qualified disaster” is within the discretion of the Secretary of the Treasury. It is not clear what criteria the Secretary will use to make this determination, and whether the definition of “qualified disaster” will be extended to events outside the United States.

Second, the legislative history to the Victims Relief Act uses the term “employer-controlled” in discussing charities that provide disaster relief to employee-beneficiaries. However, the CPE Text and the Disaster Relief Publication use different terminology: the CPE Text addresses activities by “employer related” organizations, and the Disaster Relief Publication addresses activities by “employer-sponsored” organizations. Each of these terms is undefined. Is there a substantive difference among these terms? For example, as discussed above, the CPE Text lists as one of the 14 factors that may be used to evaluate a disaster-relief program by an “employer related” public charity the requirement that the organization not be “excessively controlled” by the employer. Does this limit who may serve on the board of an “employer related,” “employer-sponsored,” or “employer-controlled” public charity or private foundation? For example, may the board of the public charity or private foundation consist of only upper-level management of the related employer? Or must lower-level employees be included to “break” control?

Third, if a corporation does not choose to establish its own disaster-relief program, either through a private foundation or public charity it controls, the corporation may still wish to provide assistance to its employees who are victims of disasters in the United States or abroad. May a public charity operating a disaster-relief program accept contributions from a corporation that requests or requires that the funds it contributes be directed to employees of the corporation? Would such “earmarking” of the corporation’s contribution be deemed to result in an impermissible private benefit to the corporation? Does it make a difference if the event that precipitated the contribution is or is not a qualified disaster?

¹³ Code section 692(c)(2) defines “terroristic or military action” as:

- any terroristic activity which a preponderance of the evidence indicates was directed against the United States or any of its allies, and
- any military action involving the Armed Forces of the United States and resulting from violence or aggression against the United States or any of its allies (or threat thereof).

¹⁴ The term “Presidentially declared disaster” in Code section 1033(h)(3) is defined in reference to the Disaster Relief and Emergency Assistance Act, which uses as its operative concept the term “major disaster.” A “major disaster” is defined, in part, as “any natural catastrophe ... or, regardless of cause, any fire, flood, or explosion, *in any part of the United States.*” (Emphasis added.)

Although these open issues are important to consider, they should not deter corporations interested in establishing disaster-relief programs from assisting their employees and other victims of civil and natural disasters.

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If you would like further information on disaster-relief assistance by employer-controlled charities, please contact Victoria B. Bjorklund (212-455-2875, vbjorklund@stblaw.com), David A. Shevlin (212-455-3682, dshevlin@stblaw.com), Jennifer Goldberg Reynoso (212-455-2287, jreynoso@stblaw.com), Jennifer L. Franklin (212-455-3597, jfranklin@stblaw.com), Joanna Pressman (212-455-2494, jpressman@stblaw.com), or any other member of the Firm's Exempt Organizations Department.

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