

CHARITIES AND DISASTER RELIEF: DO WE STILL NEED “NEED”?

In the months following September 11, this nation saw an outpouring of generosity on an unprecedented scale. According to USA Today, approximately \$2.7 billion was raised by charities for relief efforts relating to September 11.¹ As these funds began pouring in and as they continued to mount, the charities receiving these funds faced the daunting challenge of distributing these funds rapidly and fairly.

As was widely reported in the media, families of victims quickly became frustrated with the slow distribution of the funds. Widows and families of victims complained of being made to feel like beggars.² While numerous factors lead to the difficulties, not insignificant was the requirement that the distributing charity make a specific determination of the need prior to distributing funds to a grantee. As the New York Times reported, “[I]t is clear that the problem of making prompt, generous payments to victims without violating charity law affects scores of organizations that have raised money primarily for specific World Trade Center victims, like the families of one corporation or one labor union. It is especially troubling,” the Times continued, “for funds that have raised huge sums for the families of lost uniformed personnel, and that now face a wrenching realization: tax-exempt charities are generally required by law to respond to specific needs not to heroism.”³

Every lawyer who has worked with a charity proposing to provide disaster relief knows the difficult questions that can arise in advising the client on what can and cannot be done within the bounds of the Internal Revenue Code. Can a charity be formed to raise funds for a single family or a few affected families? Can a corporate foundation establish a disaster relief fund to benefit only the employees of its corporate founder? Can a charity replace an individual’s car destroyed in a disaster? These are the kinds of questions that advisors must answer in the wake of a disaster, and the answers are usually needed urgently.

The Internal Revenue Code, however, imposes numerous restrictions on charities and marks the outer boundaries of what can and cannot be done. The restrictions vary depending on the context. There is one set of rules applicable to all charities providing disaster relief. There is a second, new set of rules applicable only to charities providing relief in connection with September 11 and certain anthrax attacks. And there is a third set of rules governing the special case of a charity controlled by a company and providing relief to the company’s employees.⁴

Disaster Relief Charities Generally

Section 501(c)(3) organizations must be organized and operated exclusively for purposes listed in that section. One of the listed purposes is “charitable” purposes.⁵ The Treasury regulations

¹ USA Today, “\$1.5 B of 9/11 donations distributed,” August 20, 2002.

² See New York Times, “Charity Abundant, But So Is Red Tape, After Terror Attack,” sec. 1A, page 1, col. 2 (Oct. 28, 2001).

³ New York Times, “Victims’ Funds May Violate U.S. Tax Law,” sec. B, page 1, col. 5 (November 12, 2001).

⁴ This third set of rules will not be covered in this article.

⁵ Sec. 501(c)(3); Sec. 1.501(c)(3)-1(d)(1) and (2).

describe in some detail the kinds of activities which fall within the ambits of a “charitable” purpose.⁶ The regulations provide that, among other things, charitable purposes include such activities as the “relief of the poor and distressed or of the underprivileged . . .”.⁷ These provisions lay the foundation in the Internal Revenue Code for charities providing disaster relief, including the relief efforts relating to the attacks of September 11.

The Internal Revenue Service (“IRS”) has also provided a substantial amount of guidance relating to charitable organizations providing disaster relief generally. The most comprehensive guidance from the IRS is a 1999 continuing professional education article entitled “Disaster Relief and Emergency Hardship Programs” (the “1999 CPE Text”)⁸ That article sets forth the IRS’s position on the proper provision of disaster relief. However, the article does not reflect changes made by the Victims of Terrorism Tax Relief Act of 2001. Those changes will be discussed in other sections of this article.

One key requirement discussed is that the organization must make a determination of the needs of a particular recipient prior to providing cash assistance to that individual. The article focuses on individuals who lack adequate resources to meet basic needs as the primary candidates for disaster relief.⁹ However, it acknowledges that there are circumstances where individuals who are not needy in the traditional sense may nevertheless be proper objects of charity.¹⁰ A key concept permeating the article was tailoring the assistance provided to the needs of the particular individual and relieving them. The idea, of course, is that providing a financial windfall is not a charitable act. One person might need counseling but not money. Another person may be in need of financial support in the short term but not in the long term. The article makes clear, however, that making a victim whole generally is not appropriate charitable relief.¹¹

Another important requirement is that the class of individuals served by a particular charity must constitute a “charitable class”. This requires that the pool of individuals from which the recipients will be selected must be sufficiently large or indefinite to justify the special treatment accorded charities under state and federal law.¹² As the United States Tax Court stated in Thomason v. Commissioner,¹³ “charity begins where certainty in beneficiaries ends, for it is the uncertainty of the objects and not the mode of relieving them which forms the essential element of charity.”

⁶ Sec. 1.501(c)(3)-1(d)(2).

⁷ Id.

⁸ Exempt Organization Continuing Professional Education Technical Instruction Program for FY 1999, Chapter K (the “1999 CPE Text”). This article is available on the IRS website at www.irs.gov in the charities and non-profits section.

⁹ 1999 CPE Text, at 226-228.

¹⁰ Id. at 227.

¹¹ Id.

¹² Id. at 223-226.

¹³ 2 T.C. 441, 443 (1943).

September 11 Charities

The Problem.

Essentially, charities receiving funds were required by the Internal Revenue Code to go out and identify relief candidates with sufficient financial need to allow the charity to make significant distributions in satisfaction of those needs. While counseling and other non-financial support, as well as small amounts of financial support sufficient for immediate needs, could be distributed quickly with relatively few questions, the overwhelming majority of the funds could not be distributed absent a massive fact-finding project.

From the point of view of Charity A, a national charity with a relief effort in New York, the question would arise as to what relief could be provided to Mrs. (or Mr.) X, an individual who had lost her (or his) breadwinner in the World Trade Center. Charity A could certainly offer non-monetary assistance to the X family, and it could certainly provide a few hundred or thousand dollars for immediate needs (e.g., food, rent, clothing, etc.). However, beyond these immediate needs, the questions became complex. What is the financial situation of family X? Does the family already have millions in the bank? Does the X family have insurance or other benefits that will defray costs and ensure a comfortable lifestyle? Will the family be entitled to receive funds from the Victims Compensation Fund? If so, will that award be reduced by charitable contributions from Charity A? What are other charities giving to the X family? It should be obvious from this example, which understates the complexity facing charities, that the task of distributing funds to victims and their families posed very difficult issues. How can a charity distribute such a large amount of funds quickly and simultaneously discharge its responsibilities under the Internal Revenue Code?

Restrictions Relaxed.

Congress ultimately inquired into complaints that, while charities had raised unprecedented amounts of funds, they were not distributing the funds promptly. On November 19, 2001, the IRS issued Notice 2001-78. That notice stated in pertinent part as follows:

Congress is considering clarifying legislation in this area. While Congress is considering legislation, the Service recognizes the need to provide interim guidance to charities regarding payments made by reason of the death, injury, or wounding of an individual incurred as a result of the September 11, 2001, terrorist attacks against the United States. Accordingly, the Service will treat such payments made by a charity 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

The notice stated that it was to remain in effect until the earlier of final legislative action addressing the issues or December 31, 2002.¹⁴

¹⁴ Notice 2001-78.

On January 23, 2002, President George W. Bush signed into law the Victims of Terrorism Tax Relief Act of 2001 (the Act),¹⁵ providing sweeping tax relief in a variety of forms to aid victims of terrorism and their families. Section 104 of the Act endorses and expands the provisions of Notice 2001-78, and its provisions apply retroactively to payments made on or after September 11, 2001. That section, which will not become a part of the Internal Revenue Code, provides that where an organization described in Section 501(c)(3) makes a payment 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,” those payments will be treated as being consistent with the exempt status of the paying organization, provided the payments are made (i) in good faith and (ii) using a reasonable and objective formula which is consistently applied.¹⁶ The Act also provides that, in the case of private foundations making such payments, any such payment will not be treated as made to a disqualified person for purposes of self-dealing penalties under Section 4941.¹⁷

The legislative history to the Act¹⁸ clarifies that this provision is intended to allow charities the option of paying over relatively large sums to victims and their families without making a specific determination of the needs of the victim and his or her family. It states in pertinent part:

In light of the extraordinary distress caused by the attacks on the United States of September 11, 2001, and the subsequent attacks involving anthrax, the bill provides that organizations described in section 501(c)(3) that make payments by reason of the death, injury, wounding, or illness of an individual incurred as a result of the September 11, 2001, attacks, or as a result of an attack involving anthrax occurring on or after September 11, 2001, and before January 1, 2002, are not required to make a specific assessment of need for the payments to be related to the purpose or function constituting the basis for the organization’s exemption. This rule applies provided that the organization makes the payments in good faith using a reasonable and objective formula which is consistently applied.¹⁹

The legislative history also provides that payments must also be made for a public and not a private purpose and the class of permissible recipients must be a charitable class (i.e., large or indefinite).²⁰

Under the new provision, the favorable treatment applies only where a reasonable and objective formula is consistently applied. The legislative history, in turn, sheds some light on what is and

¹⁵ P.L. 107-134,

¹⁶ Sec. 104(a)(1) of the Act.

¹⁷ Sec. 104(a)(2) of the Act.

¹⁸ Technical Explanation of the “Victims of Terrorism Tax Relief Act of 2001” prepared by the staff of the Joint Committee on Taxation (December 21, 2001) (the “Joint Committee Report”). The text of the Joint Committee Report is available on the Joint Committee website, at www.house.gov/jct/.

¹⁹ *Id.* at 11.

²⁰ *Id.*

what is not such a formula.²¹ It explains that making pro-rata distributions to the families of firefighters killed in the attack on the World Trade Center would be permissible without taking into considering the specific needs of each family.²² It gives another example illustrating that allocating distributions based on the number of dependents in a particular family will be permissible.²³ However, making pro-rata payments based on pre-September 11 living expenses would generally not be permissible.²⁴

Finally, the legislative history indicates that charities making payments in reliance on the new provision should clearly so indicate on the charity's information return by, for example, a notation at the top of the relevant page of the return.²⁵

So How Much Need is Enough?

Going forward, some significant issues remain. Certainly, the problem of September 11 charities distributing funds rapidly has been adequately addressed, though as noted, if the unthinkable were to happen again, charities responding would be confronted with the same difficult problem and Congress would presumably be required to revisit the issue. In addition, disasters raising similar issues but not receiving such extensive national and international media attention, will presumably not receive any special treatment. For example, if a handful of firefighters were killed in a local fire, the local media might cover their deaths and rally public support in the community while national media covered it less extensively or not at all. The result in that situation could be a small number of local charities raising (for example) several million dollars for four families, all of whom had adequate insurance coverage including income replacement. The local charities could then find themselves in the position of having too much money and not enough need. The September 11 rule would not apply, no special rule would be enacted, and the charities would have a problem.

Other issues were not adequately addressed. For example, all charitable disaster relief efforts, even September 11 efforts, must be directed at a charitable class. This requirement, critical as it is, remains relatively ill-defined. The IRS makes clear that the class must be large or indefinite. But there is no clear rule as to when a charitable class is large enough to be per se charitable. The usual escape valve from this difficult determination is to make the class "indefinite." For example, the purpose of a charitable fundraising effort could be to raise funds for the five victims of the current disaster and the victims of future similar disasters in the same community. That technically satisfies the charitable class requirement. However, a charity must be organized and operated for charitable purposes. If the fund's purposes are so stated, \$2 million is raised and the

²¹ Id.

²² Id.

²³ This example seems to have been drafted with the Twin Towers Fund in mind. See New York Times, "Victims' Funds May Violate U.S. Tax Law," sec. B, page 1, col. 5 (November 12, 2001) (fund will pay over large sums based on number of dependents).

²⁴ Id.

²⁵ Id.

entire \$2 million is spent on the five victims, and the charity subsequently ceases operations, was the class really indefinite?²⁶

The bottom line is that, while the Act brought about some much-needed clarity in the law of charities providing disaster relief, many issues remain. Indeed, the only thing that is clear is that these issues will arise again in the future, and advisors will be called upon to identify the sometimes non-existent border between what works and what does not.

²⁶ See, e.g., Wendy Parker Rehabilitation Foundation, Inc. v. Commissioner, T.C. Memo 1986-348 (foundation funded primarily by family members of victim did not qualify under Section 501(c)(3) where 30 percent of foundation's income was to be spent on such victim—the foundation's namesake). See also, 1999 CPE Text at 225 (requiring a “bona fide purpose to aid others in similar circumstances in the future.”).