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INTRODUCTION

Much of the generosity prompted by the events of September 11th was channeled to public charities such as The New York Community Trust and United Way of New York City's September 11th Fund. The Fund has used approximately half of the contributions received for cash grants to individuals affected by the attacks.

In the last issue of *Professional Notes*, we discussed the often cumbersome procedures that private foundations need to follow in making grants to individuals. This issue will look at requirements for public charities such as The Trust when they make scholarship awards and cash grants in the wake of a disaster.

Section 501(c)(3) of the Internal Revenue Code¹ provides that an organization that qualifies for exemption from income tax is one that is "organized and operated exclusively" for charitable purposes (or religious, scientific testing for public safety, literary, educational purposes, or prevention of cruelty to children or animals), and "no part of the net earnings of which inures to the benefit of any private shareholder or individual." Thus, charities are required to use their assets for charitable purposes or they risk the loss of their tax exemption. Grants to individuals are not prohibited, provided they are made to further charitable purposes.

Private foundations (including those created by corporations) generally must obtain IRS approval of procedures for certain types of grants to individuals so that the grants will not be taxable expenditures. In addition, foundations created by corporations that provide scholarships to children of the corporation's employees are subject to specific restrictions. Public charities, such as The New York Community Trust, do not have to have procedures approved by the IRS; nonetheless, many of the limitations on grants to individuals that apply to private foundations are relevant to public charities.

Before embarking on any individual grantmaking program, the charity will want to make sure it is permitted to do so under its governing documents. Occasionally, these documents limit grants to *organizations*.

CHARITABLE CLASS

As a threshold issue, grants to individuals are not charitable unless there is a "charitable class" of potential recipients. This requires that the group of persons that can benefit must be either a large enough or indefinite class, so that aid to the members of the class benefits the greater community. If the persons potentially aided do not constitute a charitable class, the charity's tax exemption may be at risk as it would not be "organized and operated exclusively" for charitable purposes. There is no

¹All "Code Section" references are to the Internal Revenue Code of 1986, as amended, and all "Treas. Reg. Sec." references are to regulations promulgated thereunder.

particular number that makes a class large enough. A not very helpful example used by the IRS² indicates that a class of more than 100,000 persons whose homes have been damaged in a hurricane is large enough. Undoubtedly, some lesser number also is large enough to be a charitable class.

It is important to note that a scholarship fund or disaster relief fund cannot be created or operated to assist particular, pre-selected individuals.

It is not uncommon to have scholarships limited to a single sex or to an economically disadvantaged group. A narrowly defined class will be indefinite if as yet unidentified members of the class will be eligible in the future.

SCHOLARSHIPS AND FELLOWSHIPS

Promotion of education is a charitable purpose, and the regulations specifically recognize as educational institutions traditional primary and secondary schools and colleges, as well as trade schools, that have a regularly scheduled curriculum, a regular faculty, and an enrolled body of students in attendance. Scholarships to attend such schools similarly promote education.

Because providing for education is itself a charitable purpose, there is no legal requirement that scholarship applicants demonstrate financial need, although many programs do take need into account.

Public charities generally look to rules relating to scholarship awards by private foundations for guidance. In order to obtain IRS approval, these rules provide that grant procedures must be objective and nondiscriminatory and meet the following requirements:

1. Grantees must be selected from a group large enough to constitute a charitable class.
2. The criteria for selection of grantees must be reasonably related to the purposes of the grant.
3. Persons selecting grant recipients must not be in a position to derive a private benefit, directly or indirectly, from the selection of grantees.
4. Grants must be made according to a procedure that is reasonably calculated to result in

performance by grantees of the activities that the grants are intended to finance.

5. The foundation must obtain reports from the grantees to determine whether they have performed the intended activities.

6. A grant to an individual may be renewed if the grantor has no information indicating that the original grant was used for any purposes other than the purpose for which it was made, all reports required at the time of renewal have been submitted, and any additional criteria and procedures for renewal are objective and nondiscriminatory.

Corporate foundations are severely restricted in awarding scholarships to employees of the company that created the private foundation or their children. Specifically,

- the scholarship program may not be used to recruit employees;
- scholarships may not be awarded to more than 10% of the eligible pool of potential applicants or, in the case of scholarships for children of employees, 25% of actual applicants, if greater than the number determined under the 10% test; and
- continued employee status cannot be a requirement for renewal of the award.

Failure to observe these guidelines will result in the scholarship aid being treated as a taxable employment benefit to the employee, unless a subjective facts and circumstances test is met.

In the absence of more specific guidance, the foregoing rules are readily adapted by public charities. These procedures do not have to be approved by the IRS and can be re-evaluated as circumstances warrant. Many public charities, including The New York Community Trust, will include family of the original donor on the selection committee that reviews applicants and recommends finalists.

Where the grant is made directly to an educational institution for tuition, no further evidence of the grant's use for tuition is required. However, if the grant is paid to the student, the grantor should require a report of the recipient,

showing that the grant was used for scholarship purposes.

Under Code Section 117, scholarship grants, *i.e.*, amounts received for tuition assistance, fees, and books, are not taxable to a recipient who is a candidate for a degree at an institution described in Code Section 170(b)(1)(A)(ii). This reference to Section 170 may require that the educational organization be a recognized tax exempt institution, so that if the student attends a for-profit school (as is common with vocational schools), the recipient may be subject to tax on the grant. To the extent aid is taxable—whether because it is used for room and board, or because the school does not offer degree programs—the IRS has ruled that no withholding is required when paid to or for a U.S. citizen or resident alien. *See*, IRS Notice 87-31, 1987-1 C.B. 475. Withholding is required on such grants to foreign students for activities in the United States.

DISASTER RELIEF GRANTS

The term “charitable” is broadly defined, both in regulations and case law. Of particular relevance in the context of disaster relief are two accepted charitable purposes: relief of the poor and distressed and lessening the burdens of government. However, even if a donor contributes to a qualified charity, contributions are not deductible to the donor if earmarked for designated individuals.

In addition, payments to individuals, if not considered charitable, could be taxable income to them. This is especially likely if the fund is established by the victims’ employer, and could be recharacterized as compensation.

Relief programs rarely claim charitable status as organizations that lessen the burdens of government. According to the IRS Exempt Organization CPE Technical Instruction Program (1999), Chapter K, *Disaster Relief and Emergency Hardship Programs*, such an organization must show that its activities are those a governmental unit considers to be its burdens; the mere fact that an organization engages in an activity that sometimes

is undertaken by government is not sufficient to establish that the organization lessens the burdens of government. However, the IRS has recognized that a volunteer fire organization may lessen the burdens of government where it provides fire and rescue service for the general community.

Generally, disaster relief is considered to be relief of the poor and distressed, and requires a determination of *who* is poor or distressed. Regulations define a “needy” person as one “who lacks the necessities of life, involving physical, mental, or emotional well-being, as a result of poverty or temporary distress.” Examples include a person who is financially impoverished as a result of low income and lack of financial resources, a person who temporarily lacks food or shelter and the means to provide for it, a victim of a natural disaster or civil disaster, and a person who is temporarily not self-sufficient as a result of a sudden and severe personal or family crisis, such as a crime of violence.

Short term relief needs are treated differently from longer term relief. Immediately after a disaster, it may be reasonable to assume a family needs food, clothing, or shelter without regard to financial circumstances. Crisis counseling, rescue services, and other in-kind aid also may be provided.

Generally, longer term financial support is not appropriate for persons with adequate financial resources. The IRS publication, *Disaster Relief: Providing Assistance Through Charitable Organizations*, states that charitable funds cannot be distributed to individuals solely because they are victims of a disaster. By contrast, the regulations under Code Section 170 suggest that a victim of a civil disaster is needy or in distress, at least temporarily. Defining “need” requires objective criteria and adequate records. The IRS position is that “individuals do not have to be totally destitute to be needy; they may merely lack the resources to obtain basic necessities.” In an August 1995 letter in response to the Oklahoma City disaster, the IRS indicated that good faith decisions of need would

not be challenged, but that a transfer of funds based solely on an individual's involvement in a disaster without regard to that person's financial needs would result in excess private benefit. The IRS also said that maintaining a person's standard of living at a level satisfactory to that person rather than at a level to satisfy basic needs would overly serve private interests. For example, rebuilding an individual's luxury estate would overly serve a private rather than a public interest.

Examples of costs that traditionally could be paid include:

- Funeral expenses
- Medical expenses
- Costs to replace destroyed cars
- Travel costs to allow victims' families to attend funerals or visit the injured
- Temporary housing

Under IRS rulings, financial aid is appropriate for these costs only where the individual has inadequate resources through insurance and otherwise.

In the aftermath of September 11th, there was a spate of criticism of the standard used by the IRS, which imposed a requirement that an individual lack financial resources to provide for *basic* needs. In an apparent reaction to that criticism, the final version of *Disaster Relief: Providing Assistance Through Charitable Organizations* broadened the kinds of needs for which cash assistance may be given, provided an objective evaluation has been made of the victim's ability to meet these needs. It provides for:

- assistance to allow a surviving spouse with young children to remain at home with the children to maintain the psychological well-being of the entire family;
- assistance with elementary and secondary school tuition and higher education costs to permit a child to attend a school;
- assistance with rent, mortgage payments, or car loans to prevent loss of a primary home or transportation that would cause additional trauma to families already suffering; and

- travel costs for family members to attend funerals and to provide comfort to survivors.

Thus, financial need (*i.e.*, lack of financial resources to meet needs, including those discussed above) can be addressed with cash assistance, or other needs may be met through services such as counseling, training, and job placement services which are charitable without regard to financial need. The type of aid that is appropriate to relieve distress in a particular case depends on the nature of the individual's needs and resources.

GRANTS TO INDIVIDUALS UNDER THE VICTIMS OF TERRORISM TAX RELIEF ACT OF 2001

While the IRS was being criticized for its disaster relief guidelines, Congress was debating the appropriate response to September 11th.

Public Law 107-134, known as the Victims of Terrorism Tax Relief Act of 2001 (the "Act"), was approved by Congress in late December, and signed into law on January 23, 2002. The Act establishes a special standard for victims of the September 11th attacks and the anthrax attacks that occurred between September 11 and December 31, 2001. It provides that any payment by charity "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" is considered to be related to the exempt purpose of the charity, as long as the payments are made "in good faith using a reasonable and objective formula which is consistently applied."

Although generally need must be assessed, this provision allows exempt organizations to make payments to a narrow class of September 11th victims (deceased or injured) or their families without making a specific assessment of their needs. For example, payment amounts could be based on the number of dependents of persons constituting a charitable class who were killed in the attacks.

The Act also creates a new Code Section 139 regarding the tax treatment of payments to victims of other “qualified disasters.” New Code Section 139 addresses disaster relief generally and excludes “qualified disaster relief payments” from taxable income. Qualified disaster relief payments include payments from any source to or for the benefit of an individual to reimburse or pay reasonable and necessary (i) personal, family, living, or funeral expenses incurred as a result of a qualified disaster or (ii) expenses incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster. The term “qualified disaster” includes (i) a disaster that results from a terrorist or military action, (ii) a Presidentially declared disaster, or (iii) a disaster that results from an accident involving a common carrier, or from any other event, which is determined by the Secretary of the Treasury or his delegate to be of a catastrophic nature.

The explanation of the Act issued by the Joint Committee on Taxation (the “JCT Explanation”) provides a general rule for exempt organizations which states that an organization that provides cash assistance in good faith to victims of a qualified disaster and their family members is presumed to meet the requirements of Code Section 501(c)(3) if (i) the class of beneficiaries is sufficiently large or indefinite and (ii) the organization applies consistent, objective criteria for assessing need. The JCT Explanation also refers to education, housing and “other needs,” thereby suggesting that the IRS has defined “need” too narrowly in the past.

CONCLUSION

Scholarship programs of public charities do not require IRS approval, but generally should be modeled upon the rules applicable to such programs of private foundations. Similarly, disaster relief grants by public charities to individuals do not require prior approval of the IRS. However, in either

case, the grants will not qualify as “charitable” if there is not a sufficiently large or open-ended charitable class, and donors may not earmark contributions for particular individuals. Where a cash grant is made to address an individual’s need arising out of a disaster or emergency, an assessment must be made of that person’s need at the time of the distribution. Although no such assessment is required for victims of the September 11th terrorist attacks, it continues to be required in other cases. In any event, the kinds of needs that may be addressed have been broadened from traditionally recognized needs such as medical costs, temporary housing, and funeral expenses, to include financial aid to enable a surviving spouse to remain at home with young children, to permit a child to remain at a private school, or to enable a family to meet rent or mortgage payments on a primary home.

For further reference, see:

- Wendy Parker Rehabilitation Foundation, Inc. v. Commissioner*, T.C.M. 1968-348.
 - IRC Section 117: Scholarships.
 - IRC Section 170(b)(1)(A)(ii): Educational organizations.
 - Treas. Reg. Sec. 1.117-5(c): Qualified tuition.
 - Treas. Reg. Sec. 1.170A-4A(b)(2)(ii)(D)-(E): Needy defined.
 - Treas. Reg. Sec. 1.501(c)(3)-1(d)(2): Charitable defined.
 - Treas. Reg. Sec. 1.501(c)(3)-(1)(d)(3): Educational defined.
 - Treas. Reg. Sec. 1.1441-4(c): Withholding rules.
 - Rev. Proc. 76-47, 1976-2 C.B. 670.
 - Rev. Rul. 74-361, 1974-2 C.B. 159.
 - IRS Notice 87-31, 1987-1 C.B. 475.
 - IRS Exempt Organization CPE Technical Instruction Program (1999), Chapter K, *Disaster Relief and Emergency Hardship Programs* (Huetter and Friedlander).
 - IRS Publication (2002), *Disaster Relief: Providing Assistance Through Charitable Organizations*.
- For more information, call:**
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About The Trust

For 78 years, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust is an aggregate of funds created by individuals, families, and businesses to support the voluntary organizations that are crucial to a community's vitality.

Grants made from these funds—which now number more than 1,600—meet the needs of children, youth and families; support community development; improve the environment; promote health; assist people with special needs; and bolster education, arts, and human justice.

In addition to reviewing proposals from nonprofit agencies and responding to the grant suggestions of donors, The Trust is alert to emerging issues and develops strategies to deal with them, works with other funders and with government, and gets out information to the public. Recent initiatives have included programs that address youth violence, managed health care, immigration, child abuse, and public school reform.

The Trust is governed by a 12-member Distribution Committee composed of respected community leaders. Its staff is recognized for its expertise in grantmaking, financial administration, and donor services. Local divisions are located on Long Island and in Westchester.



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