Charitable Class and Need: Whom Should Charities Benefit?

Rochelle Korman
Patterson, Belknap, Webb & Tyler LLP
New York, New York

> The term "charitable" is used in Section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in Section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions. Such terms include: Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes…." Treas. Reg. Section 1.501(c)(3)-1(d)(2) (1959)

Introduction

The Victims of Terrorism Tax Relief Act of 2001 (hereinafter referred to as the "Terrorism Relief Act ") signed into law on January 23, 2002 and applicable to all taxable years ending on, before or after September 11, 2001, *inter alia,* provides individuals who died as a result of the April 19, 1995 and September 11, 2001 terrorist attacks on the United States with the same income and estate tax relief as already provided to members of the armed services when serving in a combat zone.

In addition, the Terrorism Relief Act of 2001: (i) created a one-time catastrophe-specific safe harbor for Code Section 501(c)(3) [1] charities that made payments

[1] All Code references are to the Internal Revenue Code of 1986, as amended.

to victims[2]; and (ii) added a new section 139 to the Code specifically excluding "qualified disaster relief payments" from the gross income of individual recipients'. Finally, the legislative history of the Terrorism Relief Act expressly reverses longstanding limitations imposed by the Internal Revenue Service ("IRS") on employer-controlled private foundations that make disaster relief payments to employee-beneficiaries, and further directs the IRS to promptly issue guidance regarding requirements applicable to such private foundations making disaster relief payments. Such guidance is to be effective with payments made in connection with September 11 and any future disasters.

The immediate period following September 11, 2001 was a terribly traumatic time, and in the stress of the moment, the IRS, elected officials, charities and practitioners[3] created an unnecessary crisis about who charities could help and what help charities could provide. This paper will explore the impact on the tax law concepts of charitable class and need of: (i) the IRS' interpretation of charitable class and need as set forth in various published pronouncements in recent years; (ii) Congress' special September 11 safe harbor legislation; and (iii) the Joint Committee on Taxation's ("JCT") charge to the IRS to issue "prompt guidance" regarding employer-controlled private foundations, an issue not addressed by Congress in the Terrorism Relief Act.

Part I will briefly summarize the history of charitable class and need as concepts integral to the law of tax exemption; Part II will address the specifics of TRA Section 104; Part III will tackle the issue of individual businesses as charitable

[2] Section 104 of the Terrorism Relief Act. This is an off-Code provision.
[3] The media's role in the confusion about the law cannot be overstated. However, I have limited my paper to tax law issues and consequences. I leave it to others to comment in detail on the collateral political and social issues.

communities; and Part IV will attempt to provide a more coherent approach going forward to determining need and charitable class.[4]

Part I—A (Very) Brief History of the Concepts of Charitable Class and Need

The Middle Ages to the Mid-20th Century

Beginning with the Revenue Act of 1894, every federal income tax law has included an exemption for "corporations, companies, or associations organized and conducted solely for charitable, religious or educational purposes". [5] Although the income tax act of 1894 was declared unconstitutional,[6] the essentials of its exemption language have remained remarkably constant over the years, and current Code Section 501(c)(3) exempts "corporations, and any community chest, fund or foundation organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes…."

However, the "grouping of religion, charity, and education as favorites of the law does not begin with American laws regarding income taxation, but has an ancient historical and legal basis." [7] And so the preamble to the English Statute of Charitable Uses

---

[4] This paper will focus on need and charitable class within the context of disaster relief. As noted in later sections of the paper, need and charitable class take on a different character when viewed through the prism of charitable purposes other than relief of the poor and/or distressed, such as promotion of health and care of the elderly.

[5] See Boris I. Bittker, and George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 Yale LJ 299, 330-333; John P. Persons, John J. Osborn, Jr., and Charles F. Feldman, *Criteria for Exemption Under Section 501(c)(3),* published in *Research Papers*, sponsored by the Commission on Private Philanthropy and Public Needs, Vol IV at 1909 (1977); Chauncey Belknap, The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy, Appendix to Persons, et al, supra, at 2025.

[6] *Pollock v. Farmers' Loan and Trust Co.*, 158 U.S. 601 (1895)

[7] Belknap, supra at 2026. Interestingly, although the exemption for religious and educational institutions migrated to America with the earliest English settlers, the exemption of "benevolent" organizations operating

of 1601 in effect codified the scope of charity that had existed in practice for more than 200 years[8]:

> Whereas lands, tenements, rents, annuities, profits, hereditaments, goods, chattels, money and stocks of money have been heretofore given, limited, appointed and assigned as well by the Queen's most excellent Majesty, and her most noble progenitors, as by sundry other well-disposed persons; *some for relief of aged, impotent and poor people, some for sick and maimed soldiers and mariners, schools of learning, free schools and scholars in universities, some for repair of bridges, ports, havens, causeways, churches, sea-banks and highways, some for education and preferment of orphans, some for or towards relief, stock or maintenance for houses of correction, some for marriages of poor maids, some for supportation, aid and help of young tradesmen, handicraftsmen and persons decayed; and others for relief or redemption of prisoners or captives, and for aid or ease of any poor inhabitants* …(emphasis added.)[9].

Fast forward 200-plus years and judges on both sides of the Atlantic articulate remarkably similar working definitions of charity. In an 1867 opinion, Justice Gray of the Massachusetts Supreme Court stated:

> A charity in the legal sense, may be more fully defined as a gift, to be applied consistently with existing laws, for the benefit of an *indefinite number of persons,* either by bringing their minds and hearts under the influence of *education or religion*, by *relieving their bodies from disease, suffering or constraint, by assisting them to establish themselves in life, or by erecting or maintaining public buildings or works or otherwise lessening the burdens of government.* (emphasis added)[10]

---

for the "relief of the poor and the sick" did not develop until the 19th century when such organizations began to supplement the care of the poor more typically provided by towns, churches and individuals. See Belknap, supra at 2029; and Persons, et al, supra at 1923.

[8] Although this paper limits historical antecedents to the Middle Ages, it is worth noting that these concepts of charity are documented in biblical and roman times. See for example, Peter Brown, *Poverty and Leadership in the Later Roman Empire,* The Menahem Stern Jerusalem lectures 2002, University Press of New England.

[9] Persons, et al, supra at 1913, footnote 10 (modern spelling courtesy of Persons, et al)

[10] *Jackson v. Phillips*, 14 Allen (Mass.) 539, 556 (1867)

Approximately 25 years later, the judges in the famous *Pemsel* case[11] were called upon to decide whether the words "charitable purposes" in the exemption provisions of the various English income tax laws are to be interpreted "according to their statutory and legal meaning, or according to their so-called popular meaning…"[12] The best known member of the panel (at least to American lawyers and academics), Lord Macnaghten, asked rhetorically "How far then…does the popular meaning of the word "charity" correspond with its legal meaning?"[13] His well-known and oft-quoted response was that

> Charity in its *legal sense* comprises four principal divisions: trusts for the relief of poverty, trusts for the advancement of education, trusts for the advancement of religion, and trusts *for other purposes beneficial to the community not falling under any of the preceding heads*." (emphasis added)[14]

Justice Gray's definition emphasizes the requirement of a charitable class ("for the benefit of an indefinite number of persons"), whereas Macnaghten's definition places the emphasis on the charitable purpose ("[c]harity in its legal sense comprises four principal divisions"). They both recognize, however, that what are now referred to in the law as "charitable class" and "need" (need being a recognized purpose), are necessarily entwined. Thus, absent a charitable class, need standing alone may be charitable, but not in the legal sense. Absent need or some other recognized charitable purpose, indefiniteness or charitable class is insufficient to satisfy the legal definition of charity.

Lord Macnaghten melds these two concepts in his explanation of his fourth category of "other purposes beneficial to the community" (*i.e.*, those that do not fall under

[11] *Special Commissioners of Income Tax v.Pemsel*, (1891) A.C. 531
[12] Id., at 55.
[13] Id., at 96.
[14] Id., at 96

the categories of advancement of religion, advancement of education, and relief of poverty). He remarks that the purposes of the fourth category are "not the less charitable in the eye of the law because incidentally they benefit the rich as well as the poor, as indeed every charity that deserves the name must do, either directly or indirectly."[15]

The present Treasury Regulations under Code Section 501(c)(3)-quoted at the beginning of this paper-gel nicely with legal and judicial antecedents, both in spirit and words. The separate categories of Code Section 501(c)(3) — religious, charitable, educational, literary, scientific, etc.? are not self-contained or mutually exclusive. Furthermore, stating that "charitable" is to be used in its "generally accepted legal sense" acknowledges that the term can and most likely will evolve over time not solely through legislation but through judicial and administrative interpretation. Over the past century, key commentators, from Scott on Trusts[16] to Bogert[17] to the Restatement[18], and federal and state courts, have all expressed the notion that it is not only impossible, but a mistake, to attempt to formulate a clear definition of charity because "charitable activity constantly

[15] Id., at 96. Macnaghten exhibited a wonderful grasp of the intrinsic problem of setting boundaries to the definition of charity. He uses the example of an educated layperson who is asked to define charity, and he speculates that such a person would speak to relief of the poor and the advancement of religion and of education, but not to the fourth category. He contrasts the hypothetical layman's reaction to being told that a gift to the Chancellor of the Exchequer for the benefit of the nation was a charity (reaction is amusement) versus being told that a gift of a lifeboat or of a pure water supply to a crowded neighborhood was charitable even though the object was not to advance religion or education or to relieve the poor (reaction is agreement). Finally, Macnaghten suggests that in the end, the response of the educated layman to the question of what is the meaning of a trust for charitable purposes "would most probably reply 'That sounds like a legal phrase; you had better ask a lawyer.'"

[16] IV Scott on Trusts, Section 368.

[17] George G. Bogert and George T. Bogert, *Trusts and Trustees* (2d edition), Section 368

[18] Restatement (Second) of Trusts, Section 368, Comment b. (1957)

changes…" and the question of what is charitable arises in "a number of different contexts".[19]

The grounding principle for defining charitable is whether an organization's purposes and activities are, in Lord Macnaghten's words, "beneficial to the community." The concepts of private inurement vs. private benefit vs. public benefit, incidental vs. substantial, are all derivative. Saying that, of course, does not answer to the question of how to define charitable class and need in the 21st century—in fact, it may even beg the question, as there is overriding agreement that the definition of charity is ever elusive and evolving.

The Law of Charitable Class and Need Prior to the Terrorism Relief Act of 2001

In 1995, the National Office of the IRS issued written guidance (the "1995 Guidance") to the District office in Oklahoma City in response to questions regarding activities of charities responding to the April,1995 bombing of the Federal building in Oklahoma City.[20] Part I of the 1995 Guidance sets out a description of the "General Law of Charity in Disaster Situations." Thus, the IRS states, *inter alia*, that:

> (i) The "cardinal principle" of exemption is that an organization must serve a public rather than a private interest, and in *appropriate* circumstances, relieving distress serves such a public interest;
>
> (ii) Persons may qualify as distressed even if they would otherwise not qualify as poor;

[19] Persons, et al, supra, at 1934-35.
[20] *IRS Guidance Letter for Relief Efforts in Oklahoma City,* Internal Revenue Service (August 25, 1995).

(iii) A disaster relief organization must have in place prior to distribution, a set of objective criteria by which it can determine who is financially distressed in order to be certain that the class of beneficiaries was not overly limited or pre-selected;

(iv) The documentation requirements will depend upon the nature of the disaster and the relief required, *e.g.*, immediate relief needs will not require the same degree of documentation as long-term assistance;

(v) Individuals may be entitled to short-term but not long-term aid;

(vi) An organization can avoid the "limited class" problem if its beneficiaries "constitute a traditional charitable class" *and* are indefinite either because of their large numbers or by defining the class of beneficiaries in an open-ended manner.

All but one of these general points are clear and I believe, correct. The trouble begins with item (iii) above, and continues in earnest in Part II of the 1995 Guidance, where in Q and A format, the Service applies these principles and provides guidance to twelve specific factual circumstances, several of which are set forth below.

Question 1. *What can a charity do to meet the long-term concerns such as education for orphans or children injured in a disaster? (emphasis added).*

The IRS responds that beneficiaries must constitute a "traditionally charitable class" and must be indefinite in size or open-ended (meaning that beneficiaries cannot be limited to victims of a particular disaster if the charity is established just to assist victims of that disaster). The indefiniteness criterion can be met by not limiting aid to the particular children who were victims of this particular tragedy. And, the IRS goes on to say, "[a]lthough funds can be set aside currently, the actual selection of appropriate beneficiaries must be made at the time the educational [or medical relief][21] is granted."

[21] The phrase "medical relief" in a response to a hypothetical question about education is puzzling, and so I have treated it as an inadvertent comment by the IRS.

But, isn't this explanation too constrained? Perhaps children who were injured and/or orphaned by Timothy McVeigh's terrorist act do not by themselves constitute a charitable class, but surely they are part of the charitable class of people in or connected to Oklahoma City at the time of the attack--- residents, visitors and their extended families. And, since advancement of education and relief of the distressed both are recognized charitable purposes unconnected to financial need, why couldn't a scholarship fund be set up now for those children?

Question 2. *Whether providing funds to individuals who require medical treatment or post trauma counseling as a result of a disaster is a charitable expenditure.*

The IRS responds that where direct medical assistance, etc. is provided to disaster victims, public benefit outweighs private benefit, presumably because the immediate need makes the individual's financial circumstances incidental, and analogizes such services to a suicide hotline or a drug treatment facility. However, the IRS goes on to say that a prerequisite for providing funds to such people for such medical or counseling purposes is detailed, needs-based documentation.

This makes no sense. The promotion of health is a charitable purpose. Likewise, providing direct medical assistance serves a charitable purpose, regardless of the victim's financial status. Providing funds to people for these purposes should only require documentation that the expense was incurred, not that the individual is financially needy. Of course, a charity as a matter of policy, may choose to limit such assistance to financially needy individuals, but tax law does not and ought not so require.

Question 3. *Is a charitable class defined by loss or need? Should donated funds be used to make a victim "whole"? Should victims be paid a "lump sum" benefit rather than having to justify specific needs?*

The IRS' response is that the needy and distressed constitute a charitable class, so long as the class is otherwise indefinite. Furthermore, needy and distressed can include those who are not financially needy (e.g., even middle-class and wealthy people can be lost at sea or trapped by a snowstorm or flood). But, the 1995 Guidance goes on to say that a showing of inadequate resources is required to help individuals, who because of a disaster, " are lacking in funds and temporarily not able to meet basic living requirements such as food, housing, clothing, transportation and medical care." Finally, making a person whole or paying a lump sum on account of a loss caused by a disaster does not necessarily serve charitable purposes. Losing an uninsured vacation home to a storm does not necessarily make a person a proper object of charity. And, providing assistance to those who have temporarily or permanently lost their only home requires an examination of the victim's needs and resources. "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."

The problem with the IRS' response is that it conflates charitable purpose with charitable class. "Need" and "distress" define a charitable purpose, similar to advancement of education, advancement of religion and maintenance of public works. But, "need" and "distress" do not define a charitable class. Providing assistance to an indefinite group of people (a charitable class) to alleviate need or distress (a charitable purpose) is a charitable activity for tax law purposes. By separating these threads, the response to

whether charities can make people financially whole becomes clearer. The answer is that although people who are victims of a disaster constitute a charitable class, the charity first must define what the charity means by promising to "make people whole". Maintaining families accustomed to a high standard of living at that standard is not a per se charitable activity. However, providing school tuition for a period of time to an otherwise non-financially needy family during a period of chaos following a disaster may very well be an appropriate charitable activity.

Question 5. *Are the following expenditures made for persons directly affected by the bombing appropriate disbursements by a 501(c)(3) organization administering funds for disaster relief?*

The IRS responded that, in general, good-faith decision-making would protect charities from challenges to their exemption. However, the fundamental guideline to proper charitable expenditures was "lack of adequate resources to alleviate the distress caused by the Oklahoma City terrorist attack." Some of the more specific items addressed were:

i *Funeral expenses?* Only if individual lacks adequate resources through insurance or otherwise.

ii *Medical expenses of those injured by the blast?* Only if individual lacks adequate resources through insurance or otherwise.

iii *Payments to replace destroyed automobiles?* Only if individual lacks adequate resources through insurance or otherwise.

iv *Grants of limited dollars to families of those killed or injured to replace lost income.* No. Relief may be temporary if resources are inadequate; the amount of relief does not necessarily equate with the income lost; financial circumstances of disaster victims may change over time.

v *Travel expenditures for families of victims?* Only if resources are inadequate.

vi *Does it make a difference whether funds are spent directly to protect the families' shelter or to provide food and clothing?* No, so long as resources from insurance or otherwise are inadequate to meet basic living needs.

Thus, the IRS infused the concept of good faith decision-making with a requirement that the charity apply a means test to each expense incurred immediately after a disaster. In sum, the 1995 Guidance interpreted a handful of rulings and basic concepts of class and need to characterize disaster relief as more a process of making sure people didn't "rip off" the system, rather than enabling charities to exercise their best judgment to determine needs and to provide help to victims of disaster. It borders on the oxymoronic to say that good-faith decision-making in disaster situations will not be challenged so long as the decision is based upon a well-documented and time-consuming determination of the proposed beneficiary's immediate needs.

In its 1999 CPE Text[22] the IRS restated and expanded the 1995 Guidance's discussion of the rules governing exemption for organizations that provide relief to the "needy and distressed".[23] Although the article does not retrace the law from the Statutes of Elizabeth, it provides a good overview of the legal doctrines that exempt relief organizations. Referencing Scott on Trusts and Bogert, as well as various revenue rulings [24] and judicial decisions[25], the article restates the two required factors of community

[22] Huetter, Ruth Rivera and Friedlander, Marvin, *Disaster Relief and Emergency Hardship Programs*,1999 IRS Continuing Education Text, Topic K, page 219.

[23] Although Treas. Reg. Section 1.501(c)(3)-1(d) refers to "needy and distressed", consistent with prior judicial interpretations of charitable activity, the IRS interprets that phrase to mean "needy *or* distressed". See, for example, Rev. Rul. 79-18, 1979-1 C.B. 194 (providing housing for the elderly is tax-exempt); Rev. Rul. 78-99, 1978-1 C.B. 152 (counseling widows is an exempt activity).

[24] For example, Rev. Rul. 55-406, 1955-1 C.B. 73 (organization that provides funds to benefit widows and children of police officers and firefighters killed in the line of duty is exempt where directors have full discretion to make decisions); Rev. Rul. 74-361, 1974-2 C.B. 159 (providing fire and rescue services for the general community lessens the burdens of government). See also Rev. Rul 69-174, 1969-1 C.B. 149

benefit and the indefiniteness of the charitable class to be served along with the IRS' interpretation of the proper application of these principles.

However, once again, the definition of needy or distressed in the context of disaster relief is exceedingly and unnecessarily narrow. It appears that the source of this restraint arises from the IRS' mistaken and continuing reliance upon the definition of "needy" found in the Section 170 Regulations interpreting Code Section 170(e)(3).[26] Code Section 170(e)(3) limits the deductibility of contributions by businesses of inventory and other equipment to qualified charities that provide care of the ill, needy or infants. Code Sections 170 and 501(c)(3) may have points of overlap, but they are not co-extensive. Section 170(c)(2)(B) references appropriate objects of deductible charitable contributions using the language of Section 501(c)(3)—"organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes…." The definition of "charitable" then is found in the Code Section 501(c)(3) regulations. And, as previously noted, charitable is a broad and evolving term. Code Section 170(e)(3) articulates parameters solely and exclusively for deductibility of business inventory, and thus, should not necessarily define what is charitable for purposes of Code Section 501(c)(3).

It ought not be too problematic (debatable perhaps, but not paralyzing), to apply the concepts of charitable class and need to specific circumstances and the IRS'

(organization providing free emergency rescue services to the stranded and injured as well as to victims of floods, fire, or other disasters is exempt).

[25] See *Russell v. Allen*, 107 U.S. 163 (1882) and *Thomason v. Commissioner*, 2 T.C. 441 (1943).

[26] See Treas. Reg. Section 1.170A-4A(b)(2)(D). I acknowledge that I have not yet researched the legislative history of the Section 170(e)(3) provisions governing the special rules deduction for contributions to qualified charities of certain inventory and other property for the care of the ill, the needy, and infants.

general exposition of the law is almost workable.[27] However, the IRS created a trap for itself when it attempted to define specific boundaries and factors for one set of circumstances using the regulations applicable to a very different issue - contributions by businesses of inventory. Thus, the IRS developed applications of the concepts of need and charitable class with the very precision and detail that, in effect, stymies the ability of these concepts to serve their intended purposes and to evolve. And so, the IRS set itself on a course that not only directly conflicts with the generally accepted fourth category of Lord Macnaghten's (*i.e.,* charities that operate for purposes beneficial to the community that are not covered by the categories of relief of the poor, advancement or religion and advancement of education), but also and more importantly, conflicts with the Regulations under Code Section 501(c)(3).

The 1995 Guidance and its successors require a needs assessment for virtually every type of payment, without allowing charities to take other factors into account, such as timing, psychological needs, community well-being. What does the oft-repeated phrase in the 1995 Guidance, "inadequate resources" mean? For example, would charitable purposes have not been furthered if with a minimum of paper work, families in Oklahoma City were provided immediate modest sums (or promises of reimbursement to bring relatives in for funerals and memorial services)? Would it be an improper use of charitable resources if local agencies in Oklahoma City subsidized several local restaurants to provide meals to affected families for, say, two weeks? Applying a needs-based analysis

[27] Most recently, the IRS reiterated its understanding of the history of the law and its specific applicability in its advance release of a special publication on disaster relief. *Disaster Relief: Providing Assistance through Charitable Organizations (Advance text),* Internal Revenue Service, Fall, 2001. The IRS subsequently revised portions of the Disaster Relief text to comply with the directives of the JCT (see Part IV).

for all payments made or services provided in a disaster undermines disaster response. This is not to suggest that cash payments are *the* appropriate response to disaster or tragedy. It is to suggest that direct cash payments may at times be the better and more efficient way to enable victims to secure the services they need. There undoubtedly will be some fraud. However, the prospect of fraud should not be the barrier to furthering exempt charitable purposes.

Part II--The Terrorism Relief Act —Section 104

Section 104 is brief and provides that for purposes of the Internal Revenue Code of 1986 and effective for payments made on or after September 11, 2001:

> "(1) payments made by an organization described in section 501(c)(3) of such Code by reason of the death, injury, wounding, or illness of an individual incurred as a 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; and
>
> (2) in the case of a private foundation…any payment described in paragraph (1) shall not be treated as made to a disqualified person for purposes of section 4941 of such Code."
>
> (emphasis added)

In explaining section 104, the JCT states that in light of the "extraordinary distress" caused by the attacks of September 11,2001, charities that make payments to individuals referenced in the provision are not required to make a specific assessment of need in order for the payments to be in furtherance of the charity's tax-exempt purposes,

so long as the payments are made in good faith, using a reasonable and objective formula which is consistently applied. Victims and their families are deemed to be a *per se* charitable class and may receive lump sum pro rata distributions without taking specific financial needs into account. However, it is not charitable if the result is to favor ("provide significantly greater assistance") to persons in a " better financial position to provide for themselves than to persons with fewer financial resources."

The legislative history goes on to say that charities making payments in connection with the September 11, 2001 attacks are not required to make lump sum pro-rata distributions, but instead may choose to follow present law. The paragraph explaining the application of the "present law rules" in fact exhibits an excellent understanding of the law as interpreted by major commentators and judges for a very long time, to wit:

> "[I]t is expected that because of the severity of distress arising out of the September 11 and anthrax attacks and the extensive variety of needs that the thousands of victims and their family members may have, a wide array of expenses will be consistent with operation for exclusively charitable purposes. For instance, payments to permit a surviving spouse with young children to remain at home with the children rather than being forced to enter the workplace seems to be appropriate to maintain the psychological well-being of the entire family. Similarly, assistance with elementary and secondary school tuition to permit a child to remain in the same educational environment seems to be appropriate, as does assistance needed for higher education. Assistance with rent or mortgage payments for the family's principal residence or car loans also seems to be appropriate to forestall losses of a home or transportation that would cause additional trauma for families already suffering. Other types of assistance that the scope of the tragedy makes it difficult to anticipate may also serve a charitable purpose."

Imagine if the above legislative history had been the operative paragraph of the 1995 Guidance and subsequent IRS publications. And, if Congress, rather than deeming payments that are not in furtherance of charitable purposes to be charitable *in this one set of circumstances only,* instead either crafted the above paragraph into legislation, or better yet, gave the IRS the nod to re-insert the definitional flexibility contemplated by the courts, we all could have been spared the unhelpful spectacle of Congressional posturing, the media's feeding frenzy, and an overly confused and at times angry public. Unfortunately, the IRS had boxed itself into a corner, especially since 1995, and the politics of responding to the September 11 disaster probably made it impossible for the IRS, one of Congress' favorite targets, to rethink and then reapply longstanding concepts.

All that being said, it is disappointing that the IRS contrived such an analytic conundrum for itself in disaster relief law. This is especially unfortunate because the IRS has expanded the scope of the law of charity in other areas, without the "help" of Congress. For example, what must a hospital do to meet the community benefit standard and be tax-exempt? In 1956, a hospital, *inter alia,* had to be "operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay."[28] The 1956 ruling was modified in 1969 to require maintenance of a full-time emergency room open to everyone, regardless of ability to pay[29]. In 1983, the Service *reinterpreted* Rev. Rul. 69-545, but without any formal modification or clarification, to allow exemption to a hospital that did not operate an

[28] Rev. Rul. 56-185, 1956-1 C.B. 202
[29] Rev. Rul. 69-545, 1969-2 C.B. 117

emergency room because there were other "significant factors that may be considered in determining whether a hospital promotes the health of a class of persons broad enough so that the community benefits."[30]

Similarly, promotion of racial integration in housing is an exempt purpose[31], but certainly wasn't before *Brown v. Board of Education*. Providing free legal services to indigent individuals constitutes relief of the poor and distressed[32]. Likewise, no one would debate the IRS' ruling that operating a drug rescue center and a telephone drug crisis service for people with drug problems[33] constitutes an exempt activity, regardless of the beneficiaries' financial needs; yet, such facilities as we know them, didn't exist 100 years ago. The IRS in the 1995 Guidance notes that beneficiaries of long-term help must be members of a "traditionally" charitable class. Yet, the service itself recognizes that discrimination based on race, gender, sexual orientation, and age has created new charitable classes that weren't recognized as such even 50 years ago.

In summary, we are left to reconcile one-time legislation that addresses a disaster that, for charitable tax law purposes is treated differently from other horrific events. It confuses concepts of income and estate tax relief with Code Section 501(c)(3) charitable purposes; it gives the public the impression that there is no efficient way to

[30] Rev. Rul. 83-157, 1983-2 C.B. 94
[31] Rev. Rul. 68-655, 1968-2 C.B 213
[32] Rev. Rul. 69-161, 1969-1 C.B.149.
[33] Rev. Rul. 70-590, 1970-2 C.B. 116

make gifts for victim assistance; and it also creates enormous confusion about the difference between a tort fund and charity.[34]

Part III—Company Foundations and Charitable Class

The legislative history of the Terrorist Relief Act also concluded that "an employer-controlled private foundation is not providing an inappropriate benefit and is not disqualified from exemption under section 501(c)(3)" by making payments to company employees who are victims of a qualified disaster as defined under newly-enacted Code Section 139. The IRS was instructed (and it has complied[35]) to reconsider its existing ruling position[36] to ensure that such a company may make charitable, tax-deductible contributions to its own foundation to aid its own employees in the event of a disaster.

The problem with both the IRS' revocation of its prior letter rulings and the JCT's instructions is not that such payments necessarily constitute impermissible private benefit to the employer, but rather that the employees of IBM or Exxon do not (and ought not, I believe, as a matter of public policy) constitute a charitable class or community for Code Section 501(c)(3) tax-exempt purposes. It is true that the employee body of any business is open-ended and indefinite—employees come and go, they retire, get fired, quit, die. However, if Merrill Lynch, Enron, GE, and Halliburton are communities in the charitable class sense, then so is every apartment building (cooperative, condominium or rental), every block association, and every local coffee house (as it wouldn't be fair to

[34] I think this last point took many of us by surprise.
[35] *Disaster Relief: Providing Assistance Through Charitable Organizations*, Internal Revenue Service TE/GE, 2002.
[36] See PLR 199917077 (January 29, 1999), revoking PLR 9544023 (August 3, 1995); PLR 199914040 (January 7, 1999), revoking PLR 9516047 (January 23, 1995)

permit Starbucks to qualify as a community for charitable purposes, but not the local independent café). Yet, for tax law purposes, an apartment building is commonly not even entitled to tax-exempt status as a civic organization under Code Section 501(c)(4).[37]

To be fair, the definition of a community under Code Section 501(c)(4) is vague, ambiguous, and oftentimes confusing, particularly when one attempts to distinguish Code Section 501(c)(3) organizations from Code Section 501(c)(4) organizations.[38] Courts and the IRS have struggled with the lack of legislative history under Code Section 501(c)(4). The three most detailed discussions of "community" for Code Section 501(c)(4) purposes are found in *Eden Hall Farm v. U.S.,*[39] the Service's published non-acquiescence [40], and the 1981 CPE Text.[41] Interestingly, none of the commentators mentioned earlier in this paper attempt a definition of community, perhaps because they assume "we know it when we see it."

In *Eden Hall*, a testator left funds to establish a vacation home "where working girls and women of proper character may go from time to time" for vacation, rest and recreation. Initially, the organization secured exemption under Section 101(6) of the

---

[37] See Rev. Rul. 74-99, 1974-1 C.B. 131 for a detailed discussion of the circumstances when a homeowners' association may qualify as a community for purposes of Section 501(c)(4).

[38] *Columbia Park and Recreation Association, Inc. v. Commissioner,* 88 T.C. No. 1 (1987). Columbia Park and Recreation Association (the "Association"), a 501(c)(4) organization, sought 501(c)(3) classification. At the time, Columbia, Maryland was an unincorporated experimental private development with 100,000 residents that offered low, middle, and high income housing integrated with business, industrial and recreational facilities. It is not a political subdivision. The Tax Court rejected the Association's argument that its size caused it to be a inherently charitable class, saying that "mere size does not transform an otherwise noncharitable, private organization to a "charitable" one." Supra, at p.42

[39] 389 F. Supp. 858 (U.S. DC, W.Pa. 1975)

[40] Rev. Rul 80-205, 1980-2 C.B. 184

[41] "Social Welfare: What Does it Mean? How Much Private Benefit is Permissible? What is a Community?", *Exempt Organizations Continuing Professional Education Technical Instruction Program for 1981*, Part I, Chapter G, pp. 95-127.

Internal Revenue Code of 1939, the predecessor of Code Section 501(c)(3). In 1969, the IRS not only revoked the organization's 501(c)(3) status but also denied its application for Code Section 501(c)(4) status. [42] Interestingly, the organization recognized and accepted that it was not exempt under Code Section 501(c)(3).

Although the testator was an executive with H.J. Heinz, his will did not limit access to the farm to Heinz company employees, although preference was to be given to applicants residing in Allegheny County (which in 1939 presumably was largely H.J. Heinz territory). Management and control of Eden Farm Hall was vested in a board of trustees all of whom were required to be Heinz employees during their tenure as trustees. Prior to 1959, the trustees limited access to the facilities to Heinz employees in the U.S. and Canada. Beginning in 1959 and through 1967, the trustees extended access to the facility to guests who also were working women, teachers within a designated school district, and nurses employed at Allegheny Hospital. The district court noted that although Heinz employees constituted 80% of the guests from 1961-1967, the total number of female Heinz employees in Pittsburgh was only 1000. The remaining 20% of guests were drawn from more than 700 companies. The court goes on to say that "Considering all of the evidence, Eden Hall Farm is an institution which has served a broad community need in the sense that Congress intended, that is, that when one segment or slice of the community, in this case thousands of working women in Allegheny County, are served,

[42] Treas. Reg. Section 1.501(c)(4)-1(a)(2) provides that an organization is exclusively for the promotion of social welfare if it is primarily engaged promoting "in some way the common good and general welfare of the people of the community." The "community" is not further defined.

then the community as a whole benefits."[43] The court however did not look to legislative history as a guide.

In its non-acquiescence, the IRS states that the Treasury regulations require and prior rulings recognize that an organization claiming exemption under Code Section 501(c)(4) "must operate for the benefit of the community as a whole rather than for the benefit of a limited group."[44] In the 1981 CPE text article on social welfare, the IRS looks to the then *Webster's New World Dictionary* for a definition of "social welfare", since neither Congress nor the IRS ever formally construed the phrase. Courts and the IRS have interpreted the phrase "social welfare" broadly to mean benefits to the community (whatever that is). In attempting to clarify the double confusion caused by the vagueness of the phrases "social welfare" and "community", particularly with respect to homeowners' associations, the Service issued Rev. Rul. 74-99, in which it defines community, only somewhat helpfully, in the negative: " a community within the meaning of section 501(c)(4)...is not simply an aggregation of homeowners bound together in a structured unit formed as an integral part of a plan for the development of a real estate subdivision and the sale and purchase of homes therein." The IRS subsequently clarified Rev. Rul 74-99[45] , saying that it is impossible to formulate a precise definition of community, and that "[t]he ruling merely indicates what the term is generally understood to mean. Whether a particular homeowners' association meets the requirements of conferring benefit on a

[43] *Eden Hall Farm v. U.S.*, supra, at 866.
[44] Rev. Rul. 80-205, citing Rev. Rul 78-69, 1978-1 C.B. 156 (organization providing rush hour commuter service to all residents of a community is exempt under 501(c)(4)); Rev. Rul. 55-311, 1955-1 C.B. 72 (local organization of employees providing bus service primarily for the convenience of its members is not exempt under 501(c)(4)).
[45] Rev. Rul. 80-63, 1980-1 C.B. 116.

community must be determined according to the facts and circumstances of the individual case."

So, under a facts and circumstances approach, if Columbia, Maryland cannot qualify as a community for Code Section 501(c)(3) purposes and the IRS will not acquiesce in a Tax Court decision that classifies an organization like Eden Hall Farm as a community for Code Section 501(c)(4) purposes, how can a single company's employees be a charitable class for purposes of grantmaking by the company's private foundation?

Despite these remarkably inconsistent analyses, there is something to be said from a public policy perspective, for encouraging and incenticizing employers to provide disaster relief and emergency hardship assistance to employees. For, although there is some spirit of generosity and caring involved, many employers, particularly large companies, are unlikely to act, or act as generously, without tax incentives. Companies establish disaster relief programs under their company foundations rather than from a dedicated fund within the company because contributions to the company foundation are tax-deductible. There is no legal impediment to any company making payments to employees injured or otherwise distressed as a result of a disaster; the donor company just doesn't get a tax deduction. However, neither did any of the thousands and thousands of people who left money at firehouses after September 11. And, it is highly unlikely that many, or even most, of the hundreds of thousands of people who contributed to the American Red Cross, the September 11 Fund, the United Way of New York City, and

hundreds of charities around the country were even thinking about tax deductions when they sent in cash and checks.[46]

It is helpful to note that new Code Section 139 exempts from gross income any payments received by individuals in connection with qualified disasters, thereby minimizing the need for the IRS to rule separately on the taxability of disaster relief payments made in connection with specific events.[47] If, as a matter of public policy, we believe that it is important to encourage private businesses to make such payments, then rather than (a) contort the definition of charitable class to include the employees of a particular Fortune 500 Company and (b) require that Fortune 500 Company Foundation to utilize a methodology of an "independent selection committee or adequate substitute procedures"[48] (which can then become the object of requests by practitioners to the IRS for clarification and guidance for years to come), I suggest that it would be preferable and more sensible for Congress to make such payments a deductible expense under Code Section 162 (or a special section), while retaining the exclusion from recipients' gross income.

---

[46] This raises the issue of public confusion about what the public intended and what Code Section 501(c)(3) allows charities to do. This is an important issue outside the scope of this paper, but one which requires attention by the sector and ideally, some help from the press.

[47] See for example, Rev. Rul. 76-144, 1976-1 C.B. 17 (grants received pursuant to Section 408 of the Disaster Relief Act of 1974 are in the interest of the general welfare and not includible in the gross income of recipients); Rev. Rul 98-19, 1998-1 C.B. 840 (disaster relief relocation payments received under the Housing and Community Development Act of 1974 are excludible from gross income.)

[48] I recognize that the JCT in the legislative history of the Terrorism Relief Act was attempting to adapt the procedures established by the IRS for scholarship programs operated by company foundations. However, it's important to note that in order for company foundations to award scholarships to children of employees, recipients in each year are limited to 25% of employees' children who were eligible, who were applicants, and who were considered by the selection committee. Rev. Proc. 76-47, 1976-2 C.B. 670, amplified, clarified, and modified with respect to other requirements.

Part IV—Where Are We and Where Should We Be Going?

Following the confusion created by September 11th legislation, the tax law definition of "need" within the context of disaster relief does seem to be settling into a more sensible context. It appears that following the passage of the Terrorism Relief Act and the IRS implementation of the JCT directive, the IRS' operating explanation of assessing need moved beyond the 1995 Guidance and embraced more flexible approaches. In Publication 3833, the IRS states that the "scope of the assessment required to support the need for assistance may vary depending upon the circumstances". More significantly, the IRS expressly recognizes that need includes a variety of legitimate short-term and long-term assistance, such as mortgage payments, school tuition, and special travel expenses.[49]

On the other hand, the definition of charitable class remains muddled, and the inconsistencies have been exacerbated (although certainly not caused) by the JCT directive to the IRS to provide guidance that employees of a particular company can constitute a charitable class. Thus, in its just-released CPE Text for 2003, the IRS explains that: (a) the group to be benefited must be sufficiently large or indefinite so that the community as a whole is benefited; (b) the requirement of a charitable class was not waived with respect to September 11; and (c) that a pre-selected group does not constitute a charitable class. However, in the FAQ section of the article, in response to the question, "Can we establish a charity for the families of five firefighers from one firehouse who died in the September 11 attack? Or the 50 employees from one employer? Or the one resident from a town who died?," the IRS states:

[49] Internal Revenue Service, *Disaster Relief: providing* assistance *through charitable organizations,"* Publication 3833, pp.5-6.

All the surrounding facts and circumstances need to be considered in determining whether a charity is serving a too narrowly drawn class of beneficiaries. Nevertheless, an indefinite charitable class can be established for the current and future firefighers or employees or residents who are victims of a disaster….Although the charity is organized for current and future victims, the organization can decide to use all the available funds to meet the charitable needs of current victims….The [distribution] formula for distribution of relief aid must be consistent with the special rule of the Victims of Terrorism Relief Act [if applicable]…or the normal rule that looks to an assessment of individual need or distress."[50]

I believe that this language is a recipe for further confusion. The IRS quite appropriately looked aside when, in the wake of September 11, practitioners created charities using the magic language in the purposes clause that the charity exists to serve victims of current and future disasters, all of us knowing full well that the intent and plan was to distribute all funds to victims of September 11. However, it would be a mistake to codify what was allowed following September 11. The IRS ought not validate the notion that a *de facto* pre-selected class is permitted so long as the purposes clause contemplates indefiniteness. In effect, this approach vitiates the Code Section 501(c)(3) operational test in disaster relief situations. This is a serious legal problem as well as a future public relations mess in the making.

Nonetheless, we can take some comfort in the fact that over the past several hundred years, many smart people have thought about the issues of charity, need/charitable class and charitable purpose.[51] The consensus generally reached by the

---

[50] Janet Gitterman and Marvin Friedlander, *Disaster Relief – Current Developments"*, Exempt Organizations -Technical Instruction Program for FY 2003, pp. M12-M13.

[51] The Strategy Unit/Home Office of the UK Government has recently released a 97 page "Consultation Paper", which reviews and makes recommendations regarding the law of charities. This document is now the subject of a public review and comment period through December 31, 2002. The paper recommends that the concept of public benefit continue as central to the definition of charitable status, and that the concept be applied more consistently. It is not clear from the paper whether a "company foundation" established for

courts, the IRS, commentators, and even the Joint Committee on Taxation (absent one special identifiable circumstance) is that aid to the needy or distressed falls within the concept of charitable purpose, and the definition of need will evolve over time. No statute (other than off-Code Section 104 of the Terrorism Relief Act) or judicial decision has ever suggested that pro-rata or lump-sum cash payments unrelated to relieving recognized needs or distress is in furtherance of tax-exempt charitable purposes. Congress of course could have made Section 104 applicable to all catastrophes or disasters, but it chose not to do so. It appears that the one-time applicability of Section 104 reflects what Congress perceived as a response to political pressure "just this once." Perhaps Section 104 could have been avoided had the IRS not continued to define need in so narrow and time-limited way, using regulations that arguably are not applicable to Code Section 501(c)(3) organizations. And, if not, we at least would be on firmer ground than having the Joint Committee on Taxation legislate in a crisis.

Notwithstanding Section 104, we need to think about ways to address the public's expectations for pro-rata payments, lump-sum distributions, and one-time new charities (or charities that exist to provide assistance to a pre-defined class, such as firefighers belonging to a particular firehouse or the employees of a particular company). Perhaps key local charities, such as community foundations and United Ways, could create Code Section 501(c)(4) affiliates able to handle those expectations. Individuals and business could make non-deductible contributions to the Code Section 501(c)(4) organization after a particular disaster and those funds would be distributed to the victims

---

the benefit of the company's employees serves a public benefit. The paper may be accessed at http://image.guardian.co.uk/sys-files/Society/documents/2002/09/25/strat.pdf

of that disaster according to a publicized, objective formula, akin to the rules of the Section 104 safe harbor for September 11th Code Section 501(c)(3) organizations.

In so doing, however, the employees of a particular company or business that happened to be based in the zone of catastrophe ought not constitute a distinct permitted charitable class either for Code Section 501(c)(3) or 501(c)(4) purposes. Rather the charitable class must consist of everyone in the community who was affected by the particular disaster. Individuals and businesses should not be permitted to make tax-deductible contributions to company foundations for the express purpose of providing disaster or emergency hardship relief to the employees of a particular company. Executives at many companies sincerely think of their employees as family; nonetheless, the tax laws do not permit tax-deductible contributions to the indefinite and open-ended class of family known as descendants. As a matter of public policy, Congress may want to encourage companies to provide for their employees who experience hardship, and can easily do so by making such payments deductible as business expenses. Providing charitable contribution deductions for these types of payments only confuses the law of charity and distorts the meaning of community.