

Disaster Relief and Section 501(c)(3) Organizations

Text version for assistive readers who prefer a text version of this course

Page 1 – Welcome

Welcome to the issue podcast on Disaster Relief and Section 501(c)(3) Organizations. We have a few announcements before we get started.

The information contained in this presentation is current as of the day it was presented, and shouldn't be considered official guidance.

No identification with actual persons (living or deceased), places, buildings and products is intended or should be inferred.

This program is being recorded and will be maintained under federal record keeping laws. Now let's get started.

Page 2 – Charities

Charity in its most basic form is providing aid to relieve human suffering caused by a natural or civil disaster or an emergency hardship. Charitable organizations have traditionally helped victims of disasters such as:

- Floods
- Fires
- Riots
- Storms, and
- Similar large-scale events.

Charities also play an important role in helping those in need because of sudden illness, death, accident, violent crime or other emergency hardship.

Page 3 – Objectives

This webcast addresses the requirements and factors to consider for tax-exempt Section 501(c)(3) organizations for disaster relief.

Our lesson objectives are to:

- Identify requirements for and characteristics of a charitable class.
- Identify elements of a “needs test.”
- Explain how an organization can exercise discretion and control.
- Describe recordkeeping best practices.
- Explain aid to businesses as a charitable activity.

Page 4 – Charitable Class

Charity has a long history. Its consistent theme is that charity must provide a benefit to a sufficiently large or indefinite class where the organization serves a public interest.

Treasury Regulations explain the essential requirement of a charitable class. Regulations, published guidance, such as Revenue Rulings and Revenue Procedures, and court cases elaborate that basic rule.

Treasury Regulation Section 1.501(c)(3)-1(d)(1)(ii) states that a Section 501(c)(3) organization must:

- Serve a public, rather than a private interest
- Show it hasn’t been formed to benefit designated individuals

You may also refer to *Restatement 2d of Trusts*, Section 375.

Page 5 – Charitable Class – Indefiniteness

The group of individuals that may receive help from a tax-exempt charitable organization is called a “charitable class.”

A charitable class must be large enough or sufficiently indefinite that the community as a whole, rather than a pre-selected group of people, benefits when a charity provides assistance.

For example, a charitable class could consist of the individuals in a city, county or state. This charitable class is large enough that the potential beneficiaries can’t be individually identified and providing benefits to this group would help the entire community.

If the group of eligible beneficiaries is limited to a smaller group, such as the employees of a particular employer, the group of persons eligible for assistance must be indefinite. To be considered to benefit an indefinite class, the proposed relief program must be:

- Open-ended, and
- Include employees affected by the current disaster and may be affected by a future disaster.

Therefore, if a charity follows a policy of helping employees who are victims of all disasters, present or future, it would provide assistance to an indefinite charitable class. If a charity's facts and circumstances indicate that its newly established disaster relief program is intended to benefit only victims of a current disaster without intending to help victims of future disasters, the organization wouldn't benefit a charitable class.

Because of the requirement that exempt organizations must serve a charitable class, a tax-exempt disaster relief or emergency hardship organization can't target and limit its assistance to specific individuals, such as a few persons injured in a particular fire. In the *Russell v. Allen* court case, the Supreme Court stated that charitable trusts "may, and indeed must, be for the benefit of an indefinite number of persons; for if all the beneficiaries are personally designated, the trust lacks the essential element of indefiniteness, which is one characteristic of a legal charity."

Similarly, donors can't earmark contributions to a charitable organization for a particular individual or family. Having earmarked funds or contributions for the benefit of designated individuals suggests that the organization is formed for the benefit of the designated individuals.

In the *Wendy Parker* court case, the court found that because the organization was formed in response to Wendy Parker's coma, this was significant in determining its purpose. Although the organization was created by the Parker family to aid an open-ended class of "victims of coma" it stated that it anticipated spending 30 percent of its income for the benefit of Wendy Parker. Also, the Parker family made significant contributions and controlled the organization. Wendy, being the substantial recipient of funds, benefited the Parker family by helping with the economic burden of caring for her. The benefit did not flow primarily to the general public as required under Regulations 1.501(c)(3)-1(d)(1)(ii).

Donors **may** earmark for specific causes, and the organization can decide how to apply the funds.

Page 6 – Charitable Class – Factors to Consider

In reviewing cases involving disaster relief organizations, consider these factors.

- **Class size benefited**

Treasury Regulation Section 1.501(c)(3)-1(d)(ii) indicates that an organization is not organized or operated exclusively for Section 501(c)(3) purposes unless it serves a public rather than a private interest. Thus, an organization must prove that it is not organized or operated to benefit private interests such as:

- Designated individuals
- The creator or his family
- Shareholders of the organization, or
- Persons controlled (directly or indirectly) by private interests.

The large group size from which beneficiaries will be chosen can support the public interest argument. If the class is large enough that the performance of the trust sufficiently benefits the community, the organization will be considered charitable. For example, an organization formed to help the victims of a hurricane, terrorist attack or similar disaster of mass proportion may be less likely to benefit a limited class, even though the number of potential beneficiaries may be fixed, because the individuals affected will most likely include an entire community or similar scope.

- **Open or closed class of beneficiaries**

A disaster relief or emergency hardship organization will avoid the problem of a limited class if, in addition to meeting the other organizational and operational requirements, it openly defines its class of beneficiaries. For example, an organization might be formed to help injured fire fighters or families of firefighters who died in action. This open-ended class would include victims of future fires, rather than being limited to victims of a particular fire. If the class is open-ended, the presence of beneficiaries does not prohibit exemption under IRC 501(c)(3).

Also, organizations formed to help victims of disasters in which a significant portion of the community is affected, are less susceptible to being formed for the benefit of a limited class, even though there may be a fixed number of potential beneficiaries.

- **Reason for an organization's formation**

The catalyst for an organization forming may reveal that the organization was established for the benefit of pre-selected individuals, even though it was supposedly established to benefit an open-ended class. For example, in Rev. Rul. 67-367, a nonprofit organization whose sole activity was operating a scholarship plan for paying to pre-selected, specifically named individuals did not qualify for exemption under Section 501(c)(3) because it was serving private interests rather than public charitable and educational interests.

- **Earmarked funds**

In *Wendy Parker*, the court also noted that funds were mostly contributed to Wendy Parker's family, which also controlled the organization. While a charity may set aside and use funds for the immediate victims and their families, it must have a bona fide purpose to help others in similar circumstances. Appropriate criteria for selecting beneficiaries for future relief (such as educational grants or children of victims) would include need and/or merit at the time the grant is awarded. See Rev. Rul. 69-257.

- **How assistance is publicized**

If an organization publicizes the availability of funds, this may indicate the organization seeks to help anyone who fits its criteria, rather than a narrow, pre-selected class. On the other hand, an organization's lack of publicity may indicate that it seeks to benefit a limited class.

- **Broad community involvement**

An organization's broad community involvement decreases the possibility that the organization serves narrow private interests. Community involvement could be fund raising, contributions, board or other leadership positions, or other ways.

- **Duration of organization**

It's not unusual for a disaster relief organization to be of limited duration. And while limited duration doesn't prohibit exemption, it may raise some questions as to the organization's intent and the indefiniteness of beneficiaries.

- **Plan for distribution of excess funds**

An organization formed for a particular disaster or for a limited duration should have a plan for distributing excess funds when the organization dissolves per IRC 501(c)(3). For example, once the organization meets its basic necessities, it must distribute excess funds to qualified charities or to the federal, state or local government for a public purpose. An organization can't prorate excess funds among the victims.

You must consider each situation based on all its facts and circumstances.

Page 7 – Needs Test

When an organization distributes funds to individuals to relieve financial distress, it must generally base the distribution on that individual's demonstrated need.

Therefore, before a disaster relief organization distributes funds, it must establish an objective "needs test" or other criteria to identify individuals who qualify for assistance.

It's not necessary to prove evidence of financial need when providing distressed individuals nonmonetary assistance such as counseling and other supportive services.

See Revenue Rulings 78-99, 70-590, and 71-99 for examples. There are other situations in which individuals are not financially needy, but may be distressed and require assistance. For example, individuals who are lost at sea or trapped by a snowstorm, flood, or other disaster would be considered a charitable class regardless of their financial condition.

Making an individual whole because of a disaster or emergency hardship doesn't necessarily further charitable purposes. The amount needed to relieve the distress should be based on the individual's facts and circumstances and the charity's resources. An outright transfer of funds based only on an individual's involvement in a disaster or without resolving the individual's distress or financial needs could result in private benefit. For example, if an individual's uninsured vacation residence is destroyed in a disaster, he or she experienced a loss. However, that person is not necessarily distressed and needy.

Charity aid is not an automatic right. Maintaining a person's standard of living rather than satisfying basic needs could serve private interests. For example, rebuilding an individual's luxury estate would serve a private rather than a public interest while meeting the individual's basic needs may be limited to providing temporary housing. Similarly, grants that replace lost income instead of meeting basic living needs would be viewed as serving personal and private interests. This issue is especially relevant when the contributions a person receives in response to a disaster exceeds his or her immediate needs.

Page 8 – Discretion and Control

A charitable organization, when using discretion to distribute funds, must consider:

- Its charitable purposes
- The public benefit of its activities, and
- The specific needs and resources of each victim.

Under federal law, qualified tax-exempt charities should have full control and authority over the funds donated to them. Contributors may not earmark funds for the benefit of a particular fund or family. They may however, earmark the funds for flood relief, hurricane relief, or other relief.

Rev. Rul. 68-489 states that an organization doesn't jeopardize its exemption under Section 501(c)(3), even when it distributes funds to nonexempt organizations, provided it retains control and discretion over the funds' use for Section 501(c)(3) purposes. An exempt organization:

1. Ensures that funds are used for Section 501(c)(3) purposes by limiting distributions to specific projects that further its exempt purposes.
2. And it retains control and discretion over the use of the funds by maintaining records showing that the funds were used for Section 501(c)(3) purposes.

Page 9 – Documentation – Generally

Rev. Rul. 56-304 indicates that organizations are not prohibited from making distributions of their funds to individuals, if they make their distributions on a true charitable basis to further their charitable purposes.

An organization must maintain adequate records and case histories to show that:

- Its payments further the organization's charitable purposes
- The victims they serve are needy or distressed.
- And finally, to show they've appropriately assessed recipients' needs based on their financial resources and their physical, mental, and emotional well-being.

Charities should include in their documentation of providing aid:

- A complete description of the assistance provided
- Costs
- Purpose
- The objective criteria they use to disburse assistance under each program

Page 10 – Documentation (cont.)

- How they selected recipients
- Each recipient's name, address, and amount distributed
- Relationship between a recipient and an organization's board members, key employees, or substantial contributors, and
- The make-up of the selection committee who approves the assistance.

Page 11 – Documentation – Short-Term Aid

In the previous two slides, we discussed providing aid to individuals in general, especially if recipients will need long-term or substantial assistance. However, if the organization provides only short-term or emergency aid (such as distributing blankets, electric fans, coats, hats or gloves), there may be less concern about excessive private benefit. In these cases, an organization may have sufficient limited documentation to show it's operating for an exempt purpose. Limited documentation would show:

- The type of assistance
- Criteria for disbursing assistance
- The date and place where they provided assistance
- An estimated number of victims helped (individual names and addresses are not required)
- The charitable purpose, and
- The cost of aid

Page 12 – Aid to Business

Under certain circumstances, an exempt organization might accomplish a charitable purpose by providing disaster assistance to a business. However:

- The assistance needs to be a **reasonable** means of accomplishing a charitable purpose and
- Any benefit to a private interest must be **incidental** to accomplishing a charitable purpose. Private benefit is considered incidental if the benefit the business receives:
 - Is necessary or unavoidable in accomplishing the charitable purpose, and
 - Is not excessive.

One of the charitable purposes in helping businesses is lessening the burdens of government. A charity may make grants to help a governmental unit that provides disaster assistance to businesses. This aid may be a grant to the governmental unit, which uses the funds to pay businesses. Or, the charity may give a grant directly to the business, which is qualified for aid from the governmental unit, relieving the governmental unit of providing assistance.

Rev. Ruls. 85-1 and 85-2, set the criteria for determining whether an organization's activities lessen the burdens of government.

A charity may also accomplish a charitable purpose by helping a business to combat community deterioration. For example, a tornado severely damaged a community's central business district. The area is devastated. No business attempts restoration unless assured that the entire business district will be restored.

A charitable organization may provide funds to begin rebuilding the infrastructure of the district, such as for roads, sidewalks, parks, sewers and power lines. This type of help

accomplishes a charitable purpose by combating community deterioration. Any benefit to the businesses is incidental to the charity's public purpose of community assistance.

In another example, several destroyed businesses in the central business district didn't have the resources or access to conventional financing to begin restoration. Without the charity's help, the business district would have lost these businesses resulting in lost employment opportunities for unemployed or underemployed residents.

A charitable organization may provide funds through grants, low-cost loans, or equity investments to these businesses sufficient to ensure that they remain in the area and employ unemployed or underemployed residents. This type of assistance accomplishes charitable purposes by combating community deterioration. Any benefit to the businesses is incidental to the charitable purpose accomplished.

There must be a clear connection between the aid provided to businesses, and accomplishing a charitable purpose. If there is no connection, it's likely that the aid serves the business's private interest instead. Comparing Rev. Rul. 74-587 with Rev. Rul. 77-111 shows how this principle can affect an organization's exemption based on combating community deterioration.

Page 13 – Resources

Additional disaster relief resources are available on IRS.gov and StayExempt.irs.gov, an IRS educational website.

If you have tax questions that can't be answered on IRS.gov, please contact us using the link shown here.

Before you leave, please take a minute to send us an email with your feedback on this presentation. The information you provide will ensure that this and other presentations at StayExempt provide a valuable learning experience.

Please remember that this email is **only** for providing feedback on the presentations and to notify the webmaster if there's an issue with a course, a form or instructions. This email address is not intended for tax questions.

Page 14 – Thanks for Watching!

On behalf of everyone in IRS Exempt Organizations, thank you for attending this presentation.