PROVIDING FOR ONE'S OWN—EMPLOYEE RELIEF FUNDS

ALEXANDER L. REID

Why should a business engage in philanthropy? Because philanthropy is good for business, and business is good for philanthropy. A successful business is a rich nexus of relationships, talent, and assets deployed in the service of a business objective. These same relationships, talent, and assets also can be deployed for charitable objectives. Success in one arena often leads to success in the other, and the result can be a truly virtuous circle.

The tax rules that regulate the interactions between businesses and charities can be complex, but businesses should not be discouraged from creatively incorporating philanthropic activity into their operations. With the right array of charitable and noncharitable entities, contractual provisions, good governance, and thoughtful tax planning, businesses and charities may realize the full potential of their collaborative power to generate both economic returns and public benefit. For example, a business may not be able to claim a charitable contribution deduction for a payment to a charity in exchange for goods or services, but it may be able to deduct such a payment as a business expense instead. Likewise, a charity may not be able to conduct activities that are insufficiently related to the charity's mission, but such activities may be conducted through a taxable business entity.

There are nearly limitless ways in which a business may incorporate philanthropy into its activities. A business can generate goodwill by funding charitable activity through direct giving to charitable organizations, establishing a donor-advised fund, or creating an affiliated public charity or private foundation. It can promote its brand, products, and services while at the same time raising awareness of a charitable cause through corporate sponsorship or commercial co-venture. It can build employee morale through volunteerism, pro bono work, and charitable fundraising. And as described below, it can sponsor hardship and disaster relief funds, which is a way for businesses to support their employees and their employees' families in times of need.

ALEXANDER L. REID is of counsel in the Washington, DC office of Morgan, Lewis & Bockius.

The importance of planning in advance

For many businesses, charity begins at home. When financial hardship, medical emergencies, or other disasters strike an employee or his or her family, it is natural for the afflicted employee's extended network of colleagues to want to help. For this reason, many businesses establish employee hardship relief funds. Having the foresight to create a hardship fund to enable members of the community to help one another in times of need is good management, and good tax planning.

An employee hardship relief fund is a fund administered by a charitable organization for the purpose of providing financial assistance to employees affected by current and future disasters and hardships. Anyone may contribute to such a fund—employees, managers, the employing corporation itself, and the broader business community including vendors, affiliates, and customers. An independent selection committee chooses grant recipients based on an objective determination of the recipient's need or distress, typically following an application process. The selection committee is comprised of members who are not in a position to exercise substantial influence over the employer.

When it comes to disaster preparedness, a little advance planning goes a long way. If a hardship relief fund has not been established in advance, it can be difficult for those wishing to

help someone afflicted by a tragedy to make deductible charitable contributions—a frustrating situation for all concerned. This is because a charitable deduction is only permitted for gifts to charitable organizations,[1] and a gift earmarked for a particular individual or family is not a gift to a charity.[2] As a result, donors seeking to provide contributions for the purpose of helping a specific person may not be able to claim a charitable deduction.

If, however, an employee hardship relief fund has been established in advance, before the hardship has occurred or the beneficiaries of the funds have been identified, the tax issues are considerably simplified. There is no earmarking because the charity operating the fund reviews the applications for hardship assistance and selects the grant recipients, thereby retaining discretion and control over the funds. Moreover, the contributions used to help the individual will already have been received prior to the event causing the hardship and before the recipient is identified, making earmarking unnecessary. As such, contributions to employee relief funds are generally deductible.

Not only can an employee hardship fund help donors qualify for tax deductions, it can also help recipients qualify for exemption from income and employment taxes on the payments they receive from the fund. Without an employee hardship fund, it is difficult for payments made in the context of an employer-employee relationship to qualify as gifts for tax purposes, even if the purpose of the payment is humanitarian concern for the employee's well-being rather than compensation for services rendered.[3] Unless the hardship is due to a government-declared disaster,[4] an employer's hardship relief payments generally are treated as compensation rather than gifts. As a result, such payments may be subject to income and employment taxes like other compensation rather than excluded from income as a gift.

Private foundation or public charity?

Employee hardship funds can be administered by a variety of charitable entities including private foundations, public charities, community foundations, and organizations that sponsor donor-advised funds. Many corporations have already established private foundations for corporate giving; however, special attention must be given to employee hardship relief funds operated by private foundations.

Unlike public charities, which can provide assistance under any type of disaster or employee hardship situation, private foundations may provide assistance only to employees or family members affected by a qualified disaster as defined in Section 139. This is because private foundations are subject to additional requirements beyond those applicable to public charities[5] and are strictly prohibited from engaging in "self-dealing transactions" with substantial contributors and other disqualified persons.[6]

The IRS increasingly has taken the view that if a private foundation provides hardship relief grants to employees of its sponsoring corporation outside the context of a qualified disaster, the foundation substantially benefits the sponsoring corporation.[7] As a result, the IRS regards such grants as self-dealing transactions between the private foundation and the employer-sponsor. The consequences of treating such grants as self-dealing transactions are severe as the sponsoring corporation would need to undo the self-dealing transactions by reimbursing the foundation for the money given to the employees and pay a 10% excise tax on each transaction.[8] It is also possible that a private foundation may lose its tax-exempt status or fail to qualify under Section 501(c)(3) if such self-dealing transactions comprise a substantial portion of the foundation's activities.[9]

With advance planning, it is not difficult to establish an employee hardship relief fund as a

1 Specifically, organizations described in Section 170(c).

2 See Tripp, 337 F.2d 432, 14 AFTR2d 5810 (CA-7, 1964); Rev. Rul. 62-113, 1962-2 CB 10.

3 See Section 102(c) (exempting most employer-provided payments from gift treatment).

4 See Section 139 (qualified disaster relief payments excluded from income).

5 Private foundations, as defined in Section 509(a), are subject both to the requirements of Section 501(c)(3) and the private foundation excise taxes of Sections 4940-4945.

6 See Section 4941.

7 See Ltr. Rul. 199917077 (revoking Ltr. Rul. 9516047 and Ltr. Rul. 9544023, which previously held that there was no self-dealing transaction when a company foundation provided disaster assistance to employees of its corporate affiliate).

8 See Section 4941(a)(1). The excise tax increases to 200% if the act of self dealing is not corrected. See Section 4941(b)(2). Foundation managers who knowingly approve an act of self-dealing are subject to a 5% excise tax on each act of self dealing, up to a $20,000 cap imposed on a joint-and-several basis. The penalty on foundation managers increases to 50% if the act of self dealing is not corrected (which is also subject to $20,000 cap on a joint-and-several basis). See Sections 4941(a)(2) and (b)(2).

9 See Ltr. Rul. 200926033 (private foundation failed to qualify for tax-exempt status because its non-qualified disaster relief payments substantially benefitted the related company and comprised a substantial component of the foundation's activities, so the foundation was operated for a substantial non-exempt purpose).

public charity rather than as a private foundation, thereby avoiding the excise tax and, more broadly, the entire private foundation regulatory regime. In general, an employee hardship relief fund may qualify as a public charity if it normally receives more than one-third of its total support from gifts, grants, and contributions from a variety of sources over a five-year period.[10] A single donor (such as the sponsoring corporation) cannot comprise all of the public charity's funding because only 2% of the organization's total support contributed by a single donor may count toward meeting the public support test.[11] The sponsoring corporation may, however, provide up to two-thirds of the organization's total support.

For example, an organization that receives $100,000 of total support over five years would qualify as a public charity if it received gifts of $2,000 each from 17 individuals over that same five-year period because the organization would have $34,000 of public support, which is more than one third of its total support. The company could be the source of the remaining $66,000 of support.

Many businesses use fundraising for the employee relief fund as an opportunity to boost employee morale and build a positive corporate culture. Companies often encourage their employees to contribute to the employee relief fund through monthly payroll contributions. This can be a convenient mechanism for employees to contribute, and it can produce a reliable stream of public support that enables the employee relief fund to qualify as a public charity. In addition to employee contributions, the company may solicit contributions from vendors, customers, and other members of the corporate community. Some companies hold annual fundraising events, such as golf tournaments, to raise money for the employee relief fund. Given the variety of fundraising options, companies often find that it takes very little time for the employee relief fund to build up sufficient assets to begin making hardship relief grants.

Alternatively, a business may consider establishing an employee relief fund at a community foundation or at an organization that sponsors donor-advised funds (although the employee relief fund may not itself be a donor-advised fund).[12] This can be a valuable option if fundraising for a public charity is undesirable, or if the administrative burden of establishing a new charitable organization is too great. Like private foundations, however, such employee hardship relief funds are limited to qualified government-declared disasters.[13] Sponsoring organizations typically charge an administrative fee based on the size of the fund and may also charge a per-application fee for reviewing and evaluating hardship relief applications.

Conclusion

The tax law should not be viewed as an impediment to philanthropy. There is much good that can be done, and many options for doing it. Employee hardship funds are an excellent means for businesses to help those they care about most. As is so often the case, advance planning is the key to good tax compliance. ■

[10] See Sections 509(a)(1), 170(b)(1)(A)(vi).

[11] See Section 170(b)(1)(A)(vi); Reg. 1.170A-9(f)(6). This limitation does not apply to gifts from certain public charities or governmental units.

[12] A donor advised fund is a fund or account that is owned and controlled by a sponsoring public charity but separately identified from other funds or accounts by reference to the contributions of the donor who has advisory privileges with respect to the fund. See Section 4966(d)(2)(A). A donor-advised fund itself cannot make grants to individuals and therefore cannot operate an employee relief fund. See Section 4966(c)(1)(A). The IRS has issued guidance providing that an employee hardship relief fund will not be treated as a donor-advised fund if the fund meets certain requirements. See Notice 2006-109, 2006-2 CB 1121. As such, a sponsoring organization that offers donor-advised funds may also offer employee hardship relief funds.

[13] See Notice 2006-109, 2006-2 CB 1121.