The Metropolitan Corporate Counsel®

www.metrocorpcounsel.com

Volume 12, No. 6 © 2004 The Metropolitan Corporate Counsel, Inc. June 2004

Awarding Scholarships And Disaster Relief To Employees

By JoAnn Luehring

Many corporations conduct charitable activities through a company foundation. These foundations engage in significant grant-making, awarding more than $3.5 billion annually to educational, social service, health-related, environmental, arts-related and religious charities. Company foundations are also allowed to conduct charity closer to home, through scholarships and disaster relief programs that assist company employees.

However, company foundations, like all private foundations, are prohibited by the Internal Revenue Code from benefiting those who create and run them, and from benefiting individuals unless they qualify as members of a "charitable class." Obviously, scholarship and disaster relief payments to company employees might benefit both the company and individuals. The company could benefit from curtailing disruption during emergencies that affect its employees. And the potential of economic assistance may build goodwill with the employee base and might also reward employees for past services.

Direct financial aid through either program unquestionably benefits the recipients. Nevertheless, charitable activities often are intended to benefit specific persons. For example, aid to the needy, medical services to the ill, and scholarships to students all assist particular individuals. This benefit is acceptable so long as the recipients are members of a defined "charitable class" (*e.g.*, needy, ill or persons seeking education). For scholarship or disaster relief purposes, the Internal Revenue Service has acknowledged that a group of employees or their children may constitute a charitable class and thereby receive aid if the group is broad enough that the award program fulfills an objective charitable or educational purpose. The larger the number of employees involved, the easier it is to find a charitable class.

Even while providing assistance to a charitable class, company foundations (hereinafter "Foundations") cannot confer more than "incidental and tenuous" benefit on the company, a term which is interpreted to mean either small in comparison to the charity accomplished or unavoidable as a by-product of the activity. For example, a Foundation may grant funds to revitalize a blighted neighborhood, even though the company's offices are located there.

Fortunately, the IRS has provided specific guidance which helps Foundations provide scholarship and disaster relief programs for employees, yet avoid providing an impermissible benefit to the company and to individuals who are not deemed members of a charitable class.

Scholarships

Awarding scholarships may fulfill a Foundation's qualified charitable and educational purposes, if: (i) awarded on an objective and nondiscriminatory basis, (ii) awarded pursuant to a procedure approved in advance by the IRS and (iii) the scholarships qualify as nontaxable. Scholarships qualify as nontaxable if they are used for tuition, fees, books, supplies and equipment by a degree candidate at an accredited school, provided no services are required in return. They cannot be used for room and board.

Foundations are permitted to provide scholarships to employees or their natural or adopted children or step-children, if the applicant group qualifies as a charitable class. The company may place reasonable limits on eligibility, such as full-time employment or a minimum longevity with the company (up to three years).

Because scholarship programs must be approved by the IRS prior to commencement, the Foundation must submit a description of the program either with its application for exempt status[1] or as a separate request. If the IRS does not respond within 45 days, approval is deemed granted, unless and until a contrary notice is received.

In issuing Rev. Proc. 76-47[2] the IRS provided safe harbor guidelines for approval of Foundation scholarship programs, setting forth seven conditions and one percentage test. A scholarship program must meet all seven conditions, but may choose not to meet the percentage test. In the latter case, the IRS will apply a facts and circumstances test to determine whether the primary purpose of the scholarship program is to benefit the company (not permitted) or to educate employees or their children in their individual capacities (permitted). The conditions are:

1. The scholarship program cannot serve as a recruitment tool. Likelihood of receipt of a scholarship must be low enough to fail as an inducement to accept employment.

2. Recipients must be selected by persons who are and always have been unrelated to both the Foundation and the company. Most companies create an independent committee or engage a scholarship administration service. The committee or administrator, rather than the company, must announce the results.

__JoAnn Luehring__, a Partner in Roberts & Holland LLP, represents both public charities and private foundations in all aspects of their operations, from creation and securing tax exemption through general operations, special ruling requests, development and donor advice, opinion letters and dissolution. Roberts & Holland confines its practice to tax matters, with 40 tax lawyers in its New York City and Washington, DC offices.

3. The company must publish relevant qualifications to the applicant pool. In addition to requiring that applicants meet minimum standards for admission to their chosen schools, the Foundation may limit applicants to undergraduate programs, full-time enrollment, U. S. institutions, or to any other reasonable criteria. Eligibility cannot be keyed to any other employment-related factor, such as position or duties.

4. Recipients must be judged on objective educational standards that are unrelated to the applicant or the applicant's parents. Standards may include performance on scholastic aptitude tests, class rank, counselor appraisals, interests, activities and leadership contributions, and financial need.

5. A scholarship may not be terminated if the recipient or his or her parent leaves the company, and renewal of a scholarship may not be predicated on continuing employment. The recipient cannot be required to render future services to the company.

6. The company cannot dictate or limit the recipient's course of study.

7. The scholarship must qualify as non-taxable and must be awarded solely to allow the recipient to pursue an education.

Percentage Tests: If the program awards grants to employees, the number awarded cannot exceed 10% of the number of employees who applied and were considered. If the program awards grants to children of employees, the number of new scholarships awarded annually cannot exceed either 25% of the number of eligible children who applied and were considered, or 10% of the total number of employees' children eligible to apply, irrespective of whether they applied. Because it is difficult and costly to collect the information for the 10% test, Foundations generally use the 25% test.

If scholarships are awarded without meeting the foregoing criteria, the Foundation will be required to pay penalty taxes of 10% of the amount awarded, which can rise to 100% if the procedure is not corrected, and its trustees may be required to pay personally a tax of 2.5%, which could rise to 50%. In addition, the scholarship will be taxable to the recipient, and the awards may jeopardize the Foundation's tax-exempt status.

Disaster Relief

Providing assistance to employees who suffer economic damage from calamities originated in response to natural disasters, such as hurricanes and earthquakes. However, the rules governing such assistance were changed dramatically following September 11, 2001. Currently, the only situations in which a Foundation may provide emergency relief to the company's employees must be related to terrorist or military attacks, Presidentially declared disasters, some common carrier accidents, and other disasters declared by the Secretary of the Treasury. Natural disasters are no longer included unless so declared by the President. Types of aid a Foundation may provide vary from home repairs, temporary assistance with monthly financial needs, and longer-term counseling or educational needs of children.

The Foundation must meet three criteria to deliver disaster relief[3]:

1. Recipients must be members of a charitable class which is large or indefinite enough that providing aid benefits the community, not just specific individuals. This may seem incongruous for a Foundation wishing to assist company employees, but if the Foundation's program is open to current and future employees and/or covers all qualified disasters, the open-ended group may qualify. The smaller the employee base, the harder this test will be to meet, especially if the Foundation's officers and directors are chosen from the same small pool of employees.

2. Beneficiaries must be chosen by a selection committee, a majority of whose members are not influential within the company; i.e., persons independent of the company and lower-level employees.

3. The selection committee's decisions must reflect an objective determination of need which assesses the family's size, ages, income, resources and hardships. The fact alone that an individual is a victim of a disaster does not establish financial or other need. In addition, the Foundation must document the need. The Foundation must record the assistance given, the purpose of the aid, the criteria used to determine need, the procedure for selection, and the identification of each recipient. Any relationship between the recipient and any director, officer or key employee of the company or Foundation must be noted. The more extensive the aid, the more detailed the records required.

If the foregoing requirements are met, the Foundation's disaster payments will be presumed to further the Foundation's exempt purposes and count toward the Foundation's required annual charitable distributions, and will not trigger any excise tax penalties based on impermissible benefit to the company nor constitute compensation. However, even if this three-pronged test is satisfied, the IRS reserves authority to investigate specific circumstances.

Although a Foundation may accept contributions from employees and others who wish to assist with its mission, contributions cannot be earmarked for specific individuals. After a disaster, there is often an outpouring of financial support prompted by general humanitarian concerns, but also by sympathy for particular individuals. The Foundation cannot agree to channel aid to particular individuals. Similarly, a Foundation cannot use or expand its disaster relief program to aid small groups of employees in other sympathetic circumstances, such as when an employee's house burns down, or an employee dies unexpectedly leaving young children.

With either a scholarship or a disaster relief program, the Foundation's governing documents must authorize the type of activity, and the board of trustees must formally adopt the specific program. Further, payments can never be made to trustees or officers of the Foundation or the company, to members of the selection committee, or to relatives of these trustees, officers and selectors. Any such payments would constitute prohibited acts of self-dealing, triggering excise taxes on the recipient as well as individual trustees.

Recent Revenue Ruling

The IRS has published a ruling which combines Foundation disaster relief and scholarships programs. Rev. Rul. 2003-32 permits a Foundation to award scholarships to employees or their children in the event that the employee is seriously injured or killed in a qualified disaster, but without requiring Rev. Proc. 76-47's limits on the percentage of qualified recipients who are chosen. If the seven conditions of Rev. Proc. 76-47 are met, employees or their children may receive scholarships. The ruling holds that the facts and circumstances test is met in lieu of the percentage test, as the primary purpose of these scholarships is predetermined to be to educate recipients in their individual capacities, rather than to compensate employees or provide a fringe benefit. Scholarships awarded under Rev. Rul. 2003-32 are not counted under any other Foundation scholarship program.

Conclusion

A corporation, especially one with a large employee base, may find it doubly rewarding to create a Foundation or expand an existing Foundation's activities, to bring charity in-house through scholarships and disaster relief for employees and their families.

---

[1] Rev. Rul. 86-77, 1986-1 C.B. 334.
[2] 1976-2 C.B. 670.
[3] Requirements for company-sponsored foundations are contained in "Disaster Relief" available from the IRS at www.irs.gov.