

## **Disaster Relief - Current Developments**

By Janet Gitterman and Marvin Friedlander



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### **Overview**

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#### **Purpose**

This article offers a synopsis of the significant developments related to tax exempt disaster relief organizations since September 11, 2001.

- First, it provides an overview of Publication 3833, “Disaster Relief: Providing Assistance Through Charitable Organizations.”
  - Second, it highlights changes in the law enacted by the Congress in the Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-134 (2002).
  - Third, it addresses questions recently raised in the exempt organizations legal community.
  - Finally, it provides pertinent documents in several Exhibits. These include provisions of the Victims of Terrorism Tax Relief Act of 2001, IRS Notices related to the September 11 terrorist attacks, and general information related to charitable distributions to for-profit businesses affected by the September 11 terrorist attacks and taxation of relief payments in the form of annuities.
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#### **Introduction**

The American public responded to the September 11, 2001 terrorist attacks with an outpouring of contributions to charities engaged in disaster relief assistance.

Of primary importance to the Exempt Organization community is the Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-134, signed into law by the President January 23, 2002. Section 104 of the Act permits charities to provide immediate assistance to September 11 and anthrax attack victims without an individual assessment of financial need.

The Act also amended the Internal Revenue Code of 1986, inserting a new section 139, which defines qualified disasters and provides that disaster relief payments for victims of qualified disasters are excluded from income.

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## **Overview, Continued**

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### **Introduction, continued**

In addition, the technical explanation accompanying the Victims of Terrorism Tax Relief Act of 2001 directs the Service to broaden the allowed activities of private foundations with regard to disaster relief for both the general public and employee beneficiaries of employer-sponsored foundations.

These developments are explained in Publication 3833, “Disaster Relief: Providing Assistance through Charitable Organizations,” available on the IRS web site at [www.irs.gov](http://www.irs.gov) or by calling the IRS at (800) 829-3676.

The IRS processed over 300 exemption applications submitted by newly formed September 11 disaster relief organizations under expedited case processing procedures. See **Exhibit 1, Notice 2001-82**.

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## Overview, Continued

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## “Disaster Relief: Providing Assistance through Charitable Organizations”

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**Advance Text:  
Plain Language  
Publication** Within days of the September 11, 2001 terrorist attacks on the United States, the IRS posted the advance text of a plain language publication on its web site to give guidance to new and existing charitable organizations providing disaster relief to victims of the attacks. This publication was updated on March 1, 2002, to incorporate and clarify statutory changes enacted by the Congress in the Victims of Terrorism Tax Relief Act of 2001. It is now available as Publication 3833, “Disaster Relief: Providing Assistance through Charitable Organizations. An overview of the publication follows.

**Publication  
3833**

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**Charitable  
Class** The group of individuals that may properly receive assistance from a charitable organization is called a charitable class.

A charitable class must be

- large or
- indefinite enough that providing aid to members of the class benefits the community as a whole.

Because of this requirement, a tax-exempt disaster relief or emergency hardship organization cannot target and limit its assistance to specific individuals, such as a few persons injured in a particular fire.

Similarly, donors cannot earmark contributions to a charitable organization for a particular individual or family. When a disaster or emergency hardship occurs, a charitable organization may help individuals who are needy or otherwise distressed because they are part of a general class of charitable beneficiaries, provided the organization selects who gets the assistance.

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## “Disaster Relief: Providing Assistance through Charitable Organizations”, Continued

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**Selection Method to Accomplish Charity**

Once a charitable class of beneficiaries is defined, a charitable organization must select recipients based on an objective determination of need. An individual who is eligible for assistance because the individual is a victim of a disaster or emergency hardship has no automatic right to a charity’s funds.

**Example**

A charitable organization that provides disaster or emergency hardship relief does not have to make an individual whole, such as by rebuilding the individual’s uninsured home destroyed by a flood, or replacing an individual’s income after the person becomes unemployed as the result of a civil disturbance. This issue is especially relevant when the volume of contributions received in response to appeals exceeds the immediate needs.

**Charity has discretion to distribute funds**

- A charitable organization is responsible for taking into account the charitable purposes for which it was formed, the public benefit of its activities, and the specific needs and resources of each victim when using its discretion to distribute its funds.

**Needy or Distressed Test: Specific Assessment**

Generally, a disaster relief or emergency hardship organization must make a specific assessment that a recipient of aid is financially or otherwise in need.

- Individuals do not have to be totally destitute to be financially needy; they may merely lack the resources to obtain basic necessities.
- Under established rules, charitable funds cannot be distributed to individuals merely because they are victims of a disaster. Therefore:
  - An organization's decision about how its funds will be distributed must be based on an objective evaluation of the victim's needs at the time the grant is made
  - The scope of the assessment required to support the need for assistance may vary depending upon the circumstances

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## “Disaster Relief: Providing Assistance through Charitable Organizations”, Continued

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### Scope of Assessment

A charity may provide crisis counseling, rescue services, or emergency aid such as blankets or hot meals without a showing of financial need. The individuals requiring these services are distressed irrespective of financial condition. In contrast, providing long-term financial assistance to families to pay for basic housing because of a disaster or emergency hardship would require a financial need assessment before disbursing aid.

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### IRS Notice Anticipated Law Change

The Congress held hearings in November 2001 regarding problems in promptly distributing disaster relief funds to victims of the September 11 terrorist attacks. As a result, legislation was introduced to clarify the application of existing legal standards in that process.

### Notice 2001-78

While the bill which became the Victims of Terrorism Tax Relief Act of 2001 was pending in Congress, the IRS issued Notice 2001-78 in late November 2001. The Notice authorized charities to make payments to September 11 victims and their families without a specific needs test, if made in good faith and using objective standards. This standard permitted charities to decide how to provide relief to September 11 victims within broad parameters to prohibit gross abuse. At that time, Commissioner Rossotti stated, “We don’t want people who were affected by the terrorist attacks distracted by tax issues.”

The standard stated in Notice 2001-78 was superceded by section 104 of the Victims of Terrorism Tax Relief Act of 2001, Pub. Law 107-134, which is discussed below.

Notice 2001-78 is attached as **Exhibit 2**.

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### Special Rule for September 11, 2001 and Anthrax Victims

In light of the extraordinary distress caused by the terrorist attacks on the United States of September 11, 2001, and the subsequent attacks involving anthrax, Congress enacted a special statutory rule to allow charitable organizations to disburse aid to victims of these attacks and their families without the charity making a specific assessment of need.

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## “Disaster Relief: Providing Assistance through Charitable Organizations”, Continued

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### Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-134, Sec. 104

Under the Victims of Terrorism Tax Relief Act of 2001, charitable organizations making payments “by reason of the death, injury, wounding, or illness of an individual incurred as the result of the terrorist attacks against the United States on September 11, 2001, or an attack involving anthrax occurring on or after September 11, 2001 and before January 1, 2002,” are not required to make a specific assessment of need as is the case under established rules.

- This special statutory rule for September 11 relief applies **provided that the organization makes the payments in good faith using a reasonable and objective formula which is consistently applied.**
  - While a specific need assessment is not required, September 11 relief assistance still must serve a **charitable class** that is large or indefinite in size.
- 

### Definitions:

In applying this special statutory rule the IRS will interpret:

### Good faith

- **Good faith** to mean that the charity is applying its best efforts to accomplish its charitable purpose

### Reasonable and objective formula that is consistently applied

- **A reasonable and objective formula that is consistently applied** to mean that the charity is using objective distribution criteria that take into account all pertinent circumstances, including the size of the amounts distributed, to avoid impermissible private benefit.
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### Employer-Sponsored Assistance Programs

Frequently, employers fund relief programs through charitable organizations aimed at assisting their employees in coping with personal tragedy. The kinds of benefits a charitable organization can provide through an employer-sponsored assistance program depend on whether the charity is a public charity or a private foundation.

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## “Disaster Relief: Providing Assistance Through Charitable Organizations,” Continued

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**Public Charity** Public charities generally receive broad public support; private foundations receive their funding or endowment from a limited number of sources. Because financial support from the general public typically carries with it public attention to and oversight of a charity's operations, federal tax laws allow public charities to provide a broader range of assistance to employees than can be provided by private foundations.

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**Employer-Sponsored Public Charities** Public charities receive broad public support, they may establish employer-sponsored assistance programs to respond to any disaster or employee emergency hardship situations.

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**IRS Presumption for disaster relief or emergency hardship payments by employer sponsored public charity** The IRS will presume that payments made by a public charity to employees (or their family members) for employer-sponsored **disaster relief and emergency hardship** are consistent with the charity's charitable purposes if:

- The class of beneficiaries is large or indefinite (a “charitable class”),
- The recipients are selected based on an objective determination of need,\* **and**
- The selection is made using either an independent selection committee or adequate substitute procedures to ensure that any benefit to the employer is incidental and tenuous. The charity's selection committee is independent if a majority of the members of the committee consists of persons who are not in a position to exercise substantial influence over the affairs of the employer.

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**Special Rule for September 11: No specific assessment of need** \* Under the Special Rule for September 11, 2001, previously explained, eligible victims of the September 11 attacks or the anthrax attacks between September 11, 2001, and January 1, 2002, or their family members, may be selected as recipients of assistance without a specific assessment of need.

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## “Disaster Relief: Providing Assistance Through Charitable Organizations,” Continued

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**Presumption for employer sponsored public charity payments for disaster or hardship**

If these requirements are met, the public charity's payments to employees (and their families) of the employer-sponsor, in response to a disaster or emergency hardship, are presumed:

- (1) to be made for charitable purposes, and
  - (2) not to result in taxable compensation to the employees.
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**Private Foundation**

A private foundation that is employer-sponsored may make **qualified disaster** relief payments.

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**Qualified Disaster**

A **qualified disaster** includes a disaster that results from certain terroristic or military actions, a Presidentially declared disaster, a disaster that results from an accident involving a common carrier, or any other event that the Secretary of the Treasury determines is catastrophic.

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**IRS Presumption for qualified disaster payments by employer sponsored private foundation**

The IRS will presume that **qualified disaster** payments made by a private foundation to employees (or their family members) of an employer that is a disqualified person (such as a company that is a substantial contributor) are consistent with the foundation's charitable purposes if:

- The class of beneficiaries is large or indefinite (a “charitable class”),
  - The recipients are selected based on an objective determination of need,\*\* **and**
  - The selection is made using either an independent selection committee or adequate substitute procedures to ensure that any benefit to the employer is incidental and tenuous. The foundation’s selection committee is independent if a majority of the members of the committee consists of persons who are not in a position to exercise substantial influence over the affairs of the employer.
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**Special Rule for September 11: No specific assessment of need**

\*\* Under the Special Rule for September 11, 2001, previously explained, eligible victims of the September 11 attacks or the anthrax attacks between September 11, 2001, and January 1, 2002, or their family members, may be selected as recipients of assistance without a specific assessment of need.

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## “Disaster Relief: Providing Assistance Through Charitable Organizations,” Continued

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**Presumption: qualified disaster aid by employer sponsored foundation** If the requirements of this presumption are met, the foundation’s payments in response to a qualified disaster

- (1) are treated as made for charitable purposes;
- (2) do not result in prohibited self-dealing merely because the recipient is an employee (or family member of an employee) of the employer-sponsor; and
- (3) do not result in taxable compensation to the employees.

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**Documentation** An organization must maintain adequate records that demonstrate victims’ needs for the assistance provided by the charity. These records must also show that the organization’s payments further charitable purposes. Thus, records are required when aid is provided to individuals based on a specific assessment of need, as is normally the case, or under the special statutory rule for September 11, 2001 disaster relief under the Victims of Terrorism Tax Relief Act of 2001.

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**Elements of Documentation** Documentation should include:

- A complete description of the assistance
- The purpose for which the aid was given
- The charity’s objective criteria for disbursing assistance under each program
- How the recipients were selected
- The name, address, and amount distributed to each recipient
- Any relationship between a recipient and officers, directors, or key employees of or substantial contributors to the charitable organization

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**Documentation for short-term emergency assistance** A charitable organization distributing short-term emergency assistance would only be expected to maintain records such as the type of assistance provided, criteria for disbursing assistance, date, place, estimated number of victims assisted (individual names and addresses are not required), charitable purpose intended to be accomplished, and the cost of the aid. Examples of such short-term emergency aid would include blankets, hot meals, electric fans, or coats, hats, and gloves. An organization that is distributing longer-term aid should keep more detailed records.

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## Frequently Asked Questions

### 1. What is a Charitable Class?

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**Background on charitable class issue**

Defining the charitable class that an emergency hardship or disaster relief organization will benefit is a recurring issue. Often, the organization was formed in response to a particular event — natural or civil disaster, accident, crime, or illness ---- and its purpose is to aid the victims of the event.

When the event is widespread, such as a flood or hurricane, the entire community is affected. However, when the event is a more limited disaster or an emergency hardship situation, specific individuals may be identified as the beneficiaries of assistance. In the latter case, private benefit may result. This problem arose in W. L. (Wendy) Parker Rehabilitation Foundation, 52 T.C.M. 51, T.C. Memo 1986-348, where the organization was denied exemption because it conferred substantial benefits on a pre-selected individual (the child of the founder) who needed an organ transplant.

**IV A Scott, The Law of Trusts sec 375 (4<sup>th</sup> ed. 1989)**

A basic principle of the law of charity is that the community, rather than designated individuals, is served. Thus, any organization seeking exempt status must show it benefits a charitable class that is sufficiently large or indefinite so the community as a whole is benefited.

**Reg. 1.501(c)(3)-1(d)(1)(ii).**

“An organization is not organized or operated exclusively for one or more [exempt] purposes...unless it serves a public rather than a private interest...[I]t is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.”

**Large or indefinite group of persons**

In the context of the September 11 terrorist attacks, the requirement of a charitable class is not waived. This means that charities must assist a **large or indefinite group of persons**. Therefore, a disaster relief program that accepts applications from all September 11 victims at the World Trade Center passes muster. There is a community benefit to assisting this group that is comparable to the public benefit from assisting a known, but very large group of victims of a hurricane that devastates an area of the country.

**Community benefit**

**Pre-selected group not a charitable class**

However, an assistance program cannot target and limit its assistance to specific individuals, such as a few persons injured in a particular fire.

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## 2. Can we establish a charity for the families of five firefighters from one firehouse who died in the September 11 attack? How about 50 employees from one employer? Or the one resident of a town who died?

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**Indefinite class;  
not pre-selected**

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 firefighters or employees or residents who are victims of a disaster.

**Charity must  
have control of  
donations**

But, the charity must have control over donations so that contributions can be used for these current victims or future victims. The key is that the charity must have the power to decide to whom its assistance will be provided among a charitable class of beneficiaries. Contributors cannot pre-select beneficiaries as in the Wendy Parker Rehabilitation Foundation case noted above.

**Use of funds for  
current or  
future victims**

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 (e.g., victims of September 11). Or, the charity can set aside part of its funds for future beneficiaries, even though contributions were donated with the current victims in mind.

**Formula for  
distribution of  
relief**

The Service would also look at the distribution formula used by the organization to distribute aid to September 11 victims. The formula for distribution of relief aid must be consistent with the special rule of the Victims of Terrorism Tax Relief Act of 2001, or the normal rule that looks to an assessment of individual need or distress.

**Private benefit  
rules not  
waived**

However, the Victims of Terrorism Tax Relief Act does not apply to an organization whose program is truly abusive, such as where those in charge of a charity simply help themselves to the funds for their own private use, or where company executives are given benefits based on a business or personal relationship. The private benefit rules are not waived.

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### **3. Can too narrow a charitable class be remedied?**

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**Reliance on exemption letter;  
Amending Articles of Incorporation**

Exemption letters give charities reliance and protect them from retroactive revocation provided their activities are as stated in Form 1023. If the organization is in existence when the charitable class problem is identified, the Service would ask that the group of potential beneficiaries be expanded to include future victims. If an amendment to the Articles of Incorporation is necessary, this would be treated as a non-substantive amendment under Rev. Proc. 84-47, 1984-1 C.B. 545.

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### **4. What about adopt-a-family programs?**

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**Potential beneficiaries pool large or indefinite**

Adopt-a-family programs do not necessarily benefit pre-selected individuals or a narrow class if the families are drawn from a charitable class. Charities are not required to help every victim as long as the pool of potential beneficiaries is sufficiently large or indefinite that it constitutes a charitable class.

Also, many charities or churches have on-going programs to help people or parishioners in times of disaster or hardship. These programs satisfy the charitable class test because they have an indefinite number of potential recipients. The relatively few beneficiaries at any one time are selected because they meet the established objective criteria. For newly established programs, the rules for an indefinite beneficiary class would apply provided that contributions are not earmarked for a particular individual or family.

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## 5. Who is a victim?

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**Victims of  
Terrorism Tax  
Relief Act of  
2001**

Section 104 of the Victims of Terrorism Tax Relief Act of 2001 waives the normal needs assessment required before a charity provides assistance to September 11 victims and their families.

**Definition:  
September 11  
Victims**

The definition of victim for purposes of the Act is quite narrow. A victim under the Act is an individual killed, wounded, injured, or made ill by the terrorist attacks of September 11, 2001 or by the anthrax attacks between 9/11/01 and 12/31/01.

**Example**

For example, the definition of victim under the Act would include individuals who worked or lived in the vicinity of the terrorist attacks and rescue workers who suffered physical or mental health injuries. However, it would not include individuals who suffered only economic loss, not death, illness, or injury. However, individuals experiencing economic loss due to the terrorist attacks could be eligible for assistance apart from the provisions of the special rule.

**Intent of  
Special Rule**

The special rule allows for proportionate financial aid distributions to victims so long as a reasonable and objective formula is applied. The intent of the legislation was to empower charities to quickly provide emergency relief.

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## 6. What is meant by “relief of the distressed?”

**Persons may be  
“distressed”  
even if not  
“poor”**

In general, charities may undertake activities that assist needy or distressed persons, so long as these activities serve the public, rather than a private interest. Persons may qualify as distressed even if they do not otherwise qualify as poor. In appropriate circumstances, disaster relief organizations may provide goods or services to victims of disasters such as food, clothing, housing, transportation, medical assistance, or similar necessities without regard to financial need.

**Organization  
must justify  
distributions**

However, the fact that even persons who are not financially needy may be appropriate objects of relief efforts does not relieve an organization of the burden of establishing that its distributions to individuals accomplish charitable purposes rather than impermissible private purposes. A disaster relief organization must have, prior to any disbursement of funds, a set of objective criteria for making distributions to distressed individuals. The organization must maintain records to document its charitable relief efforts, though the degree of detail required depends on the kind of aid disbursed.

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## **6. What is meant by “relief of the distressed?”, Continued**

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**“Distress” -  
Examples**

Individuals have been determined to be distressed, irrespective of whether they are poor or destitute, or prior to the disaster, were members of a charitable class.

- Rev. Rul. 79-18, 1979-1 C.B. 194, provides that housing for the elderly may further a charitable purpose by relieving a distress to which the elderly may be susceptible regardless of financial condition.
  - Rev. Rul. 79-17, 1979-1 C.B. 193, provides that a hospice facility for terminally ill persons in need of specialized housing furthers a charitable purpose.
  - Rev. Rul. 78-99, 1978-1 C.B. 152, provides that an organization that provides counseling to widows during periods of grief and assists them in overcoming the legal, financial and emotional problems caused by the death of a spouse qualifies as charitable by alleviating the widows' distress.
  - Rev. Rul. 69-174, 1969-1 C.B. 149, provides that an organization that provides free emergency rescue services to stranded, injured, or lost persons and to persons suffering because of fire, flood, accident or other disaster is serving a charitable purpose.
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## 7. Can a charitable organization make relief payments by annuity?

**Answer**

Yes. Just as a charity can make lump sum payments to victims, it may use an annuity to make future or periodic payments to victims. Where a charitable organization provides an annuity instead of a cash grant, the same rules apply to determine whether the assistance is charitable.

For purposes of exclusion from income, the fair market value of the annuity is excluded as a gift as would be a cash grant. However, if the annuity is owned by the recipient rather than by the charity, then payments received as an annuity are partially taxable, and partially excluded, under the rules that apply to annuities. This is analogous to the situation where the beneficiary receives a cash grant and earns interest on the investment. The original cash grant is excluded from income as a gift, but the interest earned would be taxable income to the recipient.

If the annuity is for educational grants, the limitations of IRC 117 apply. See, **Exhibit 5**, General Information Regarding Taxation of Annuities.

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## 8. Can an organization provide disaster relief to its own members?

**Must have open-ended class; Selection based on need**

A disaster relief organization that guarantees significant benefits to its members would not qualify as carrying on charitable activities because the activities serve impermissible private interests. However, a charitable organization may provide benefits to its members or to members of another charitable organization provided the class of beneficiaries is open-ended and the selection of beneficiaries is based on each individual being needy. Rev. Rul. 56-403, 1956-2 C.B. 307 provides an example of a fraternity that has an open-ended membership group.

**No entitlement**

Persons who are members of a charitable organization cannot be **entitled** to benefits by reason of their membership, other than such insubstantial benefits as meeting attendance or receipt of newsletters. See Rev. Rul. 81-58, 1981-1 C.B. 331, and Rev. Rul. 75-199, 1975-1 C.B. 160, which state that providing sick and death benefits to members serves private interests.

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## 9. Can an IRC 501(c)(3) organization accomplish a charitable purpose by providing disaster assistance to a business?

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**Answer:** An exempt charity can accomplish a charitable purpose by providing disaster assistance to a business if--

**Yes, if the private benefit to business is incidental to accomplishing a charitable purpose**

- The assistance is a reasonable means of accomplishing a charitable purpose, and
- Any benefit to a private interest is incidental to the accomplishment of a charitable purpose. Private benefit is considered incidental if the benefit received by the business is necessary or unavoidable in achieving the charitable purpose and the private benefit is not excessive.

Three situations where disaster assistance to a business could be a reasonable means of accomplishing a charitable purpose and only incidentally serve private interests are described below.

**Situation 1:  
Aid to needy or distressed individuals**

The earning capacity of a self-employed individual or the owner of a sole proprietorship may be severely impaired by a disaster. For example, an individual's repair shop could be so severely damaged by a flood that the individual is deprived of a means of earning a livelihood. Without a livelihood and lacking access to insurance or other resources, the individual is poor and distressed.

**“Look through” business entity to individual**

In this circumstance, a grant to the individual in an amount necessary to help restore the business would help the individual to regain the ability to provide for basic necessities. This approach to disaster relief essentially “looks through” the business entity to accomplish the charitable purpose of aiding the needy or distressed individual affected by the disaster.

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## **9. Can an IRC 501(c)(3) organization accomplish a charitable purpose by providing disaster assistance to a business?, Continued**

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**Situation 2:  
Lessening the  
burdens of  
government**

A charity may make grants to help a governmental unit that is providing disaster assistance to businesses. Such aid may take the form of a grant to the governmental unit, which in turn uses the funds to provide payments to businesses. Or, a grant may be provided directly to a business that has qualified for aid from the governmental unit, thereby relieving the governmental unit of the burden of providing assistance to that business.

**Criteria**

Rev. Rul. 85-1, 1985-1 C.B. 177, and Rev. Rul. 85-2, 1985-2 C.B. 178, set out criteria for determining whether an organization's activities lessen the burdens of government. These are:

- Whether the governmental unit considers the organization's activities to be its burden; and
- Whether these activities actually lessen the burden of the governmental unit.

**Situation 3:  
Combating  
community  
deterioration**

A charity may also accomplish a charitable purpose by providing assistance to a business to combat community deterioration.

**Assistance that  
combats  
community  
deterioration**

For example, as the result of a tornado, the central business district of a community is severely damaged. Because of the devastation, the area has become blighted. No single business wants to begin restoration efforts unless it can be assured that the business district as a whole is going to be restored.

**Grants for  
infrastructure  
or environment**

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

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**9. Can an IRC 501(c)(3) organization accomplish a charitable purpose by providing disaster assistance to a business?, Continued**

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**Lack of resources or access to conventional financing**

In another example, several businesses located in the central business district that were destroyed by the tornado do not have the resources or access to conventional financing to begin restoration efforts. Without assistance from the charity, the business district will lose these businesses and employment opportunities for unemployed or underemployed persons in the area will be lost.

**Grant to induce business to locate or remain**

A charitable organization may provide funds in the form of grants, low-cost loans, or equity investments in these particular businesses sufficient to ensure that they remain in the area and provide employment to area residents who are unemployed or underemployed persons. This type of assistance would accomplish charitable purposes by combating community deterioration. Any benefit to the businesses is incidental to the public purpose accomplished.

**Importance of an exempt purpose**

If aid to businesses is to be considered compatible with accomplishing a charitable purpose, there must be a clear connection between the aid provided and the accomplishment of an exempt purpose. If that connection is not established, it is likely that aiding the businesses would serve their private interest without accomplishing any larger public purpose. How this principle can affect the qualification of an organization for exemption based on combating community deterioration can be illustrated by comparing Rev. Rul. 74-587, 1974-2 C.B. 162 with Rev. Rul. 77-111, 1977-1 C.B. 144.

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**9. Can an IRC 501(c)(3) organization accomplish a charitable purpose by providing disaster assistance to a business?, Continued**

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**Rev. Rul. 74-587**

Rev. Rul. 74-587 describes a nonprofit organization whose declared objectives included combating community deterioration through a program of financial assistance to businesses located in blighted urban areas inhabited mainly by members of disadvantaged minority groups. In selecting recipients for assistance, the organization consulted with nonprofit and governmental organizations operating anti-poverty and anti-discrimination programs and gave preference for aid to businesses that would provide training and employment opportunities for the unemployed and underemployed residents of the area. The revenue ruling concludes that the organization's program accomplished its stated charitable objectives and that the benefits received by businesses as a result of the organization's activities were merely incidental to the accomplishment of these exempt purposes. Therefore, the organization qualified for exemption under IRC 501(c)(3).

**Favorable Factors**

Important considerations supporting the favorable result were that:

- Businesses would not likely locate or remain in the area without the charity's assistance,
- The businesses selected for aid were ones which would hire unemployed or underemployed residents or the area, and
- The businesses did not have access to other sources of funds

**Rev. Rul. 77-111**

Rev. Rul. 77-111 describes two nonprofit organizations. The purpose of the organization described in Situation 1 was to increase business patronage in a deteriorated area mainly inhabited by minority groups. To accomplish its purpose, the organization purchased radio and television advertisements describing the advantages of shopping in the area and engaged in other activities designed to attract shoppers to the area.

The purpose of the organization described in Situation 2 was to stimulate retail sales in an area suffering from continued economic decline of retail sales due to construction of competing shopping areas in outlying areas of the city. To accomplish its purpose, the organization in cooperation with the city constructed a new shopping mall in the area. No financial gain accrued to the organization.

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**9. Can an IRC 501(c)(3) organization accomplish a charitable purpose by providing disaster assistance to a business?** Continued

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**Rev. Rul. 77-111, continued**

**Negative factors**

Rev. Rul. 77-111 holds that neither organization qualified for exemption because, despite some superficial similarities to the organization described in Rev. Rul. 74-587, the organizations did not accomplish any significant exempt purpose as a result of their business assistance programs. They merely promoted the private interests of the business owners. The fact that some of the owners may have been members of disadvantaged minority groups, or that the businesses may have been located in blighted neighborhoods, did not change this result. Therefore, since business promotion as an end in itself does not further any exempt purpose specified in IRC 501(c)(3), neither organization was exempt.

**When to stop assistance**

Once a damaged business has been restored to viability, or a newly attracted business is self-supporting, further assistance to the business from a charity is not appropriate because the benefit to the private interests of the business owners outweighs any charitable objective that might be accomplished. For this reason, charitable organizations providing assistance to businesses should have criteria and procedures for determining when aid to a business is no longer needed and should be discontinued.

**Treatment of contributions received by a business**

For a further discussion of whether grants made by charities to for-profit businesses affected by the September 11 terrorist attacks produce taxable income to the businesses, see **Exhibit 4**.

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## 10. What disaster relief can private foundations provide to individuals?

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**Answer:** Like public charities, private foundations can make need-based distributions to victims of disasters or to other persons who are poor and distressed. However, several issues are raised when a private foundation provides aid that favors employees of an employer that is a disqualified person with respect to the private foundation. These issues include private benefit, self-dealing, and gift versus compensation.

**Employer funded private foundation can benefit employees without self-dealing** Under the Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-134, Sec. 104, and the accompanying report of the Joint Committee on Taxation, JCX-93-01, December 21, 2001, a private foundation that is employer funded can make a grant for employees who are September 11 victims or who are victims of another qualified disaster.

The requirement for a charitable class is not waived. In addition, for qualified disaster victims, recipients must be selected based on an objective determination of need and by an independent selection committee.

If these conditions are met, then the foundation's payments in response to a qualified disaster (1) are treated as made for charitable purposes; (2) do not result in prohibited self-dealing merely because the recipient is an employee (or family member of an employee) of the employer-sponsor; and (3) do not result in taxable compensation to the employees.

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**Scholarship programs by private foundations** Scholarship programs operated by private foundations require advance approval of grant-making procedures under IRC 4945(d)(3) and (g).

In addition, employer-related scholarship and education loan grants are subject to percentage guidelines set forth in Revenue Procedures 76-47, 1976-2 C.B. 670 and 80-39, 1980-2 C.B. 772 to ensure that grants to individuals are outside a pattern of compensation and do not result in self-dealing.

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*Continued on next page*



## **10. What disaster relief can private foundations provide to individuals?** Continued

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**Scholarship programs by private foundations, continued**

Alternatively, where a scholarship or education loan program does not meet the percentage guidelines test, a facts and circumstances test may be applied to determine that scholarships or loans are neither compensatory nor self-dealing. For example, Rev. Rul. 86-90, 1986-2 C.B. 184 held that a scholarship program that awards one grant per year meets the facts and circumstances test.

**Scholarships for qualified disaster relief : facts and circumstances test**

If a private foundation's employer-related scholarship grant or educational loan program is directed to victims, or family members of victims, of the September 11 disaster or other qualified disaster, and the program otherwise satisfies the requirements of Rev. Procs. 76-47 and 80-39, the program may satisfy the facts and circumstances test.

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## **Exhibit 1 – Notice 2001-82**

INTERNAL REVENUE SERVICE

### **IRS News Release**

Media Relations Office  
For Release: September 18, 2001

Washington, D.C.

Tel.202.622.4000  
Release No: IR-2001-82

#### **IRS PROVIDES INFORMATION AND ASSISTANCE TO CHARITABLE ORGANIZATIONS HELPING DISASTER VICTIMS; AGENCY EXPEDITES TAX-EXEMPT STATUS REQUESTS**

WASHINGTON - The Internal Revenue Service today released new information to help the public use charitable organizations and announced it will speed processing of requests for tax-exempt status from new charities formed to assist victims of the September 11 terrorist attacks.

A pending IRS publication - "Disaster Relief: Providing Assistance Through Charitable Organizations" - will explain how to make contributions through existing charitable organizations and how new organizations can apply for and receive tax-exempt status. An advanced text of that publication is now available at the [www.irs.gov](http://www.irs.gov) web site.

"We have seen a massive outpouring of support from people helping the disaster effort in New York and at the Pentagon. The last thing we want is for donors or people creating new groups to run into tax questions during this tragic time," said IRS Commissioner Charles O. Rossotti. "Our information lets people keep their attention focused on helping those in need - rather than being distracted by tax issues."

The publication, which is still in the production stage, will be available later in printed form.

It discusses the legal requirements organizations must meet in order to qualify for tax-exempt status. For example, an organization that seeks to assist a particular, pre-selected person would not qualify as a charity. However, one that helps a large group of people affected by a disaster would benefit the public as a whole and therefore would qualify as a tax-exempt charitable organization.

The IRS also has established a special expedited review and approval process for new organizations seeking tax-exempt status to provide relief to the victims. New organizations should apply for tax-exempt status by filing IRS Form 1023, available at [www.irs.gov](http://www.irs.gov) and write at the top of the form "Disaster Relief, Sept. 11, 2001." The IRS will give such applications immediate attention.

Form 1023 and its instructions contain the addresses for submitting the application -one for regular mail and another for express mail or a delivery service. In addition, those seeking more information about applying for charitable tax-exempt status can call the IRS toll-free phone number for exempt organizations determinations, 1-877-829-5500.

## **Exhibit 2 – Notice 2001 – 78**

### **Part III – Administrative, Procedural, and Miscellaneous**

#### **Disaster Relief Distributions by Charities to Victims of September 11, 2001 Terrorist Attacks.**

##### **Notice 2001 - 78**

Several charities have raised questions about the practical application of existing legal standards for distributing funds to victims of the September 11, 2001 terrorist attacks against the United States. The Internal Revenue Service recognizes the unique circumstances caused by this tragedy and wishes to alleviate concerns that might otherwise delay relief to victims.

Congress is considering clarifying legislation in this area. While Congress is considering legislation, the Service recognizes the need to provide interim guidance to charities regarding payments made by reason of the death, injury or wounding of an individual incurred as a result of the September 11, 2001 terrorist attacks against the United States. Accordingly, the Service will treat such payments made by a charity to individuals and their families as related to the charity's exempt purpose provided that the payments are made in good faith using objective standards.

This administrative treatment will continue to apply to any payments made to such individuals before the earlier of final legislative action addressing these issues or December 31, 2002. The Service will consider what, if any, additional guidance is needed in this area.

Organizations that have questions concerning this notice may contact Marvin Friedlander at (202) 283-2300 (not a toll free number).

## **Exhibit 3 – Victims of Terrorism Tax Relief Act of 2001**

**page 1 of 3**

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**Section 104**

**SEC. 104. PAYMENTS BY CHARITABLE ORGANIZATIONS  
TREATED AS EXEMPT PAYMENTS.**

(a) IN GENERAL- For purposes of the Internal Revenue Code of 1986--

(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 the result of the terrorist attacks against the United States on September 11, 2001, or an attack involving anthrax occurring on or after September 11, 2001, and before January 1, 2002, 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 (as defined in section 509 of such Code), any payment described in paragraph (1) shall not be treated as made to a disqualified person for purposes of section 4941 of such Code.

(b) EFFECTIVE DATE- This section shall apply to payments made on or after September 11, 2001.

*Continued on next page*

## Exhibit 3 – Victims of Terrorism Tax Relief Act of 2001

Page 2 of 3

### IRC Sec. 139 - Disaster relief payments

- General Rule** (a) General rule. Gross income shall not include any amount received by an individual as a qualified disaster relief payment.
- Definition: Qualified disaster relief payment** (b) Qualified disaster relief payment defined. For purposes of this section, the term "**qualified disaster relief payment**" means any amount paid to or for the benefit of an individual--
- (1) to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster,
  - (2) to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster,
  - (3) by a person engaged in the furnishing or sale of transportation as a common carrier by reason of the death or personal physical injuries incurred as a result of a qualified disaster, or
  - (4) if such amount is paid by a Federal, State, or local government, or agency or instrumentality thereof, in connection with a qualified disaster in order to promote the general welfare,
- but only to the extent any expense compensated by such payment is not otherwise compensated for by insurance or otherwise.
- Definition: Qualified disaster** (c) Qualified disaster defined. For purposes of this section, the term "**qualified disaster**" means--
- (1) a disaster which results from a terroristic or military action (as defined in section 692(c)(2)),
  - (2) a Presidentially declared disaster (as defined in section 1033(h)(3)),
  - (3) a disaster which results from an accident involving a common carrier, or from any other event, which is determined by the Secretary to be of a catastrophic nature, or
  - (4) with respect to amounts described in subsection (b)(4), a disaster which is determined by an applicable Federal, State, or local authority (as determined by the Secretary) to warrant assistance from the Federal, State, or local government or agency or instrumentality thereof.
- (d) Coordination with employment taxes. For purposes of chapter 2 and subtitle C, a qualified disaster relief payment shall not be treated as net earnings from self-employment, wages, or compensation subject to tax.
- (e) No relief for certain individuals. Subsections (a) and (f) shall not apply with respect to any individual identified by the Attorney General to have been a participant or conspirator in a terroristic action (as so defined), or a representative of such individual.

## **Exhibit 3 – Victims of Terrorism Tax Relief Act of 2001**

**Page 3 of 3**

**IRC Sec. 139.  
Disaster relief  
payments,  
continued**

**Exclusion from  
gross income** (f) Exclusion of certain additional payments. Gross income shall not include any amount received as payment under section 406 of the Air Transportation Safety and System Stabilization Act [49 USCS § 40101 note].

## **Exhibit 4 - General Information Regarding Grants by Charities to For-Profit Business Entities**

2002

This general information relates to whether grants made by charities described in section 501(c)(3) of the Internal Revenue Code (hereinafter "the Code") to for-profit business entities affected by the September 11th terrorist attacks are excludible from income as gifts within the meaning of section 102 of the Code.

The following three scenarios have been considered in developing this general information:

- (1) A grant made to replace destroyed property that was used in a trade or business. For example, a pushcart vendor may receive a grant to provide the funds necessary to replace the pushcart destroyed in the terrorist attacks,
- (2) A grant made to assist relocation and reconstruction of a business. For example, a company may receive a grant to assist in relocating to new office space and in reconstructing its business records in order to continue in business.
- (3) A grant made to assist a business in meeting payroll and other operating expenses. For example, a company experiencing a significant loss of business since the terrorist attacks may receive a grant to assist it in temporarily meeting its payroll, rent, and other ongoing operational expenses.

In providing aid to businesses located in lower Manhattan, in close proximity to the World Trade Center site, charities seek to provide relief to the poor and distressed, and to combat community deterioration.

It is expected that charities will adopt and follow certain procedures in selecting business recipients to ensure that the grants will further charitable purposes and satisfy the requirements of section 501(c)(3) of the Code. For example, charities are expected to require businesses seeking grants to provide detailed information describing operations and losses. It is also expected that charities will require businesses to use grant funds solely in accordance with the intended uses and allow charities access to financial records to evaluate whether the grant funds are being used as intended.

## CONCLUSION

An examination of the facts and circumstances surrounding a section 501 (c)(3) charity's transfer to a for-profit business will govern whether the business can exclude the amount transferred from gross income under section 102 of the Code. An important factor is whether the charity makes the transfer with donative intent. Transfers by section 501(c)(3) charities to businesses in the examples described in the scenarios set forth above will qualify as gifts under section 102 of the Code assuming the transfers are primarily motivated by charitable or similar impulses and not by moral or legal obligations or anticipation of economic benefit, and are not in return for services. In these examples, the expenses incurred for business purposes consistent with the charity's grant are allocable to funds excluded from the business' gross income under section 102 of the Code. Accordingly, under section 265(a)(1) of the Code, deductions of expenses for those business purposes are not allowed to the extent of the excluded amounts.

## ANALYSIS

### A. Section 102

Section 61 of the Code provides that, except as otherwise provided, gross income means all income from whatever source derived. This definition encompasses any item representing "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion," *Commissioner v. Glenshaw Glass Co.* 348 U.S. 426, 431, reh'g denied, 349 U.S. 925 (1955).

Section 102(a) of the Code provides that gross income does not include the value of property acquired by gift. Neither the Code nor legislative history accompanying section 102 defines the term gift. A leading interpretive authority on the meaning of the term gift for section 102 purposes is *Duberstein v. Commissioner*, 363 U.S. 278 (1960).

In *Duberstein*, the Supreme Court considered two cases involving payments "made in a context with business overtones." *Id.* at 285. The Court noted that a gift proceeds from a "detached and disinterested generosity," and is made "out of affection, respect, admiration, charity or like impulses." If the payment proceeds primarily from "any moral or legal duty" or from "the incentive of anticipated benefit" of an economic nature, it is not a gift. Further, "where the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it." *Id.* (citations omitted). Thus, under *Duberstein*, a factual analysis of the circumstances surrounding the transfer in each particular case is necessary to determine the dominant reason for the transfer and whether the circumstances support a finding of donative intent. Insight into a transferor's intention can be gained by examining the factors (such as the economic need of the recipient) that the transferor considered in deciding whether to make the transfer and the form of assistance. See *United States v. Kaiser*, 363 U.S. 299 (1960).

Since *Duberstein*, the courts have consistently applied its test to determine whether a transfer is a nontaxable gift. However, there have been very few reported cases in which gift treatment has been claimed for a transfer to a for-profit business, and in each of those cases the courts concluded that the transfers were not excludible gifts. For example, in *Publishers New Press*,



*Inc. v. Commissioner*, 42 T.C. 396 (1964), a for-profit publisher solicited contributions to continue publishing its newspaper. The court applied the *Duberstein* intent test to transfers to the corporation and determined the contributions in issue were not gifts under section 102 because the funds were not furnished with detached and disinterested generosity but "were furnished by the contributors to obtain something the contributors desired . . . namely, the continued publication of the newspaper." *Id.* at 400. See also *Webber v. Commissioner* 21 T.C. 742 (1954), aff'd, 219 F.2d 834 (10th Cir. 1955) (minister who solicited funds on a radio program had to report the contributions as income because the contributions were not gifts but given in order to continue the radio program; the opinion is prior to *Duberstein* but consistent with its test); *Teleservice Co. of Wyoming Valley v. Commissioner*, 27 T.C. 722, aff'd, 254 F.2d 105 (3d Cir. 1958) (contributions provided by residents to a business in order for the residents to receive television signal transmission services were not gifts or contributions to capital but part of the price for services).

No reported case has been found in which it has been asserted that an outright transfer from a charity to a for-profit business was a nontaxable gift under section 102. The absence of authority relating to the tax treatment by the recipient of such transfers is consistent with the understanding that it is highly unusual for charities to make outright transfers to for-profit businesses. Cf. Rev. Rul. 74-587, 1974-2 C.B. 162 (charitable purposes may be served by providing low-cost or long-term loans to, or purchasing equity interests in, businesses in economically depressed areas). Nonetheless, such a transfer is properly excluded from the recipient's gross income under section 102 if it constitutes a gift under the *Duberstein* standard. Thus, such a transfer may be an excludible gift to the recipient under section 102 if it (1) proceeds from a "detached and disinterested generosity," (2) is made "out of affection, respect, admiration, charity or like impulses," (3) is not made from "any moral or legal duty" nor "the incentive of anticipated benefit" of an economic nature, and (4) is not in return for services rendered.

Accordingly, assuming the transfers by charities to businesses in the scenarios described above primarily proceed from charitable or similar impulses motivated by the needs of the recipient, and not from moral or legal obligations or anticipation of economic benefit, and are not in return for services, the transfers will qualify as gifts under section 102 of the Code. Cf. Rev. Rul. 99-44, 1999-2 C.B. 549 (payment made by charity to individual that responds to individual's needs, and does not proceed from any moral or legal duty, is motivated by detached and disinterested generosity). Similarly, if a recoverable grant (under which repayment is only required under certain circumstances) constitutes a gift from the charity to the business, the business realizes no income under section 102 of the Code.

#### B. Section 265(a)(1)

If a recipient for-profit business properly excludes a section 501(c)(3) charity's transfer from gross income under section 102(a) of the Code, then the rules preventing double tax benefits apply.

For example, section 265(a)(1) of the Code disallows any deductions which are allocable to one or more classes of income wholly exempt from federal income taxes. The purpose of section 265(a)(1) is to prevent a double tax benefit. Section 265(a)(1) applies where tax exempt income is earmarked for a specific purpose and deductions are incurred in carrying out that purpose. In that event, it is proper to conclude that some or all of the deductions are allocable to the tax

exempt income, Rev. Rul. 83-3, 1983-1 C.B. 72, mod. in part, Rev. Rul. 85-96, 1985-2 C.B. 87 (expenses allocable to allowances excluded under section 107), mod. in Part, Rev. Rul. 87-32, 87-1 C.B. 131 (to reflect section 265(a)(6) of the Code regarding certain housing allowances). A number of reported cases have concluded that deductions are disallowed under section 265(a)(1) because they were allocable to tax-exempt income. *See, e.g. Christian v. United States*, 201 F. Supp. 155 (E.D. La. 1962) (English teacher denied deduction for expenses incurred for literary research trip to England because the expenses were allocable to a tax-exempt gift and fellowship grant). *Accord Rickard v. Commissioner*, 88 T.C. 188 (1987) (section 265(a)(1) barred Indian tribe member from deducting his farm losses and an investment tax credit for farm equipment from unrelated taxable income because his farm income was exempt from tax); *Manocchio v. Commissioner*, 78 T.C. 989 (1982) (section 265(a)(1) barred a veteran pilot from deducting the cost of flight-training classes to the extent they were paid with tax-exempt reimbursement from the Veterans' Administration), aff'd on other grounds 710 F.2d 1400 (9th Cir. 1983) (based on definition of an expense under section 162, court denied pilot's expense deductions that were later reimbursed by the Veterans' Administration).

In the scenarios presented, the expenses incurred for business purposes consistent with the charity's grant are allocable to funds excluded from the business' gross income under section 102 of the Code. As a consequence, under section 265(a)(1) of the Code, deductions of expenses for those business purposes are not allowed to the extent of the excluded amount. For example, if a company receives a grant from a section 501(c)(3) charity to help pay the company's payroll expenses and the grant is excludible from gross income under section 102(a) of the Code, section disallows the company's current deductions allocable to those payroll expenses.

## Exhibit 5 - General Information Regarding Taxation of Annuities for Education Grants

This general information relates to a tax-exempt organization formed to assist the children of victims of the terrorist attacks that occurred on September 11, 2000, that plans to purchase annuities for the children that would be paid out over the four years that correspond to the years the children will be attending college. Would the entire amount of the annuity payments to the children be excluded from their gross income under section 139 of the Internal Revenue Code?

The organization is a tax-exempt public charity. It was formed to assist the children of firefighters of an engine company in New York City. No employer monies fund this organization and there is no employer control of the organization. The general public funds the charity. Grants paid in the form of annuities will be distributed in a charitable manner, as explained in IRS Publication 3833, *Disaster Relief: Providing Assistance through Charitable Organizations*.

Under Code section 61, gross income means all income from whatever source derived, including compensation for services. Other Code sections specifically exclude certain payments from gross income. The three exclusion sections that are most pertinent to your situation are Code section 102, pertaining to gifts, Code section 117, pertaining to qualified scholarships, and Code section 139, pertaining to qualified disaster relief payments. Section 72 pertains to the taxation of annuities.

Code section 102(a) provides that gross income does not include the value of property acquired by gift. The most critical factor in determining whether a payment is a gift is the transferor's intent in making the payment. *Commissioner v. Duberstein*, 363 U.S. 278 (1960). In *Duberstein*, the Supreme Court stated that a gift proceeds from a "detached and disinterested generosity," and is made "out of affection, respect, admiration, charity or like impulses." If the payment proceeds primarily from "any moral or legal duty" or from "the incentive of anticipated benefit" of an economic nature, it is not a gift. Further, "where the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it." Thus, under *Duberstein*, a factual analysis of the circumstances surrounding the transfer in each particular case is necessary to determine the dominant reason for the transfer and whether the circumstances support a finding of donative intent. Insight into a transferor's intention can be gained by examining the factors (such as the economic need of the recipient) that the transferor considered in deciding whether to make the transfer and the form of assistance. See *United States v. Kaiser*, 363 U.S. 299 (1960).

If the annuity payments are unrestricted as to use, they may be excludable from a recipient's gross income as a gift under section 102(a) if the transfers are motivated primarily by charitable or similar impulses and not by moral or legal obligations or anticipation of economic benefit, and are not in return for services. If, however, the annuity payments are restricted for education expenses, the gift exclusion under section 102(a) will not apply; however, the payments may be excludable from the recipient's gross income under section 117.

Section 117(a) provides that gross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization that is a school with a regular faculty and enrolled students that attend the school. A qualified scholarship means an amount received as a scholarship or fellowship grant to the extent the amount was used for qualified tuition and related expenses, such as tuition and fees, books, supplies, and equipment required for courses. Amounts received for room, board, and travel are not related expenses.

Scholarship or fellowship grant receipts that exceed expenses for tuition, fees, books, supplies, and certain equipment are not excludable from a recipient's gross income as a qualified scholarship under section 117.

Under section 1.117-3 of the Income Tax Regulations a scholarship is an amount paid or allowed to, or for the benefit of, a student whether an undergraduate or a graduate, to aid such individual in pursuing his studies. A fellowship grant generally is an amount paid or allowed to, or for the benefit of, an individual to aid him in the pursuit of study or research. A scholarship or fellowship grant may also be in the form of a reduction in the amount owed by the recipient to an educational organization for tuition, room and board, or any other fee.

The provisions of section 117 override those of section 102. In enacting section 117, Congress intended to subject to income taxation scholarship and fellowship grants to the extent they exceed the limitations on the exclusion provided in that section, notwithstanding section 102. Thus, a scholarship or fellowship grant that exceeds the limitations of section 117 is includible in gross income, even though it may otherwise qualify as a gift under Code section 102. See *Treas. Regs. section 1.117-1*.

Section 139(a) excludes from gross income any amount received by an individual as a qualified disaster relief payment. Section 139(b)(1) provides that the term "qualified disaster relief payment" means any amount paid to or for the benefit of an individual to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster. Therefore, the applicability of section 139 depends on whether annuity payments would defray such reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster.

The taxation of the annuity payments may also depend on whether the tax-exempt organization or the child has the actual or constructive receipt or the economic benefit of the annuity contract. If the tax-exempt organization purchases the annuity and transfers it to the child, only the amount equal to the fair market value of the annuity at the time of the transfer could qualify for any applicable exclusion from income under section 102 or section 117. In such a case the income on the annuity would not be excludable from gross income. *See Rev. Rul. 65-29, 1965-1 C.B. 59, and Rev. Rul. 76-133, 1976-1 C.B. 34.*

If the tax-exempt organization owns the annuity and pays the proceeds of the annuity to the child, the child would not have actual or constructive receipt of the annuity contract. Accordingly, all of the annuity payments would be excludable from the gross income of the child

to the extent such payments qualified for exclusion under section 102 or section 117. *See, e.g.*, Rev. Rul. 79-220, 1979-2 C.B. 74, and Rev. Rul. 79-313, 1979-2 C.B. 75.

In general, the cost of an annuity can be recovered tax-free over the period that an annuitant is to receive the payments. The amount of each payment that is more than the part that represents the annuitant's cost is taxable. Section 72 of the Code addresses the taxation of annuities.