Disaster and Hardship Relief for Employees: Common Pitfalls and How to Avoid Them

This article addresses the federal tax-related restrictions on an employer that wishes to sponsor a fund to provide assistance to its employees in the event of disaster or financial hardship. There are several options for employers to provide such disaster and hardship relief to employees. This article focuses on two possibilities: an employer-sponsored private foundation and an employer-facilitated crowdfunding arrangement. This article also discusses third-party charity providers as a possible solution to an employer’s need to provide emergency assistance. Finally, the less practicable options of establishing a public charity or a voluntary employee beneficiary association are briefly discussed but generally not recommended.

Private Foundations

One of the most straight-forward tax-favorable ways for an employer to direct needed aid to employees is through the use of an employer-sponsored private foundation. However, this solution only allows for payments to be made to employees who are victims of certain “qualified disasters.”

Private foundations are subject to special rules under the tax code, including the “self-dealing rule.” The self-dealing rule limits the ability of certain people and entities to improperly benefit from the operations of a private foundation by imposing an excise tax on certain transactions. The excise taxes are incurred both by the person benefiting from the proscribed transaction (the “disqualified person”) and, in certain cases, by the managers of the private foundation. Such excise taxes are designed to be onerous. An excise tax of 10 percent of the amount involved is imposed on the disqualified person, and a tax of 5 percent of the amount involved is imposed on any manager of the foundation who knows that the transaction constitutes self-dealing. The taxes on the self-dealer and the knowing foundation managers increase to 200 percent and 50 percent of the amount involved, respectively, in the event that the act of self-dealing is not corrected.
Any direct or indirect transfer or use of income or assets of a private foundation to or for the benefit of a “disqualified person” generally is subject to the self-dealing excise tax. The definition of “disqualified person” with respect to any private foundation includes, among others, any person who is a substantial contributor to the foundation, a foundation manager, or an owner of more than 20 percent of a corporation that is a substantial contributor to a foundation. A “substantial contributor” to a foundation is any person contributing more than $5,000 to the foundation, if such amount exceeds 2 percent of the total contributions and bequests received by the foundation as determined as of Dec. 31 of each taxable year. In general, once a donor is classified as a substantial contributor, this status is retained even if the donor would not be classified as such if the determination were made at a later date. Any employer providing any significant amount of funding to an employee disaster and hardship fund is likely a substantial contributor, and therefore a disqualified person for the purposes of the self-dealing rule.

The IRS has, in the past, taken the position that payments from an employer-sponsored disaster and hardship relief foundation to an employee constitute prohibited self-dealing, reasoning that the existence of the foundation provides a significant benefit to the company by enhancing its ability to attract new employees and its ability to retain existing employees. Therefore, payments from such funds to employees may cause excise taxes to be imposed upon the employer and the managers of the foundation.

However, there are certain limited circumstances under which an employer-sponsored private foundation may make payments to employees. In response to the Sept. 11 terrorist attacks, Congress passed legislation that caused payments to certain disaster victims and their families to be excluded from the victim’s gross income. In response to what it perceived to be the congressional intent of this legislation, the IRS has modified its position in order to allow payments by employer-sponsored private foundations to employees affected by a “qualified disaster.” A “qualified disaster” is defined as a disaster resulting from terroristic or military action, a federally declared disaster, a disaster resulting from an accident determined to be catastrophic, or, in certain cases, determined by a federal, state or local authority to warrant government assistance.

Payments from an employer-sponsored foundation to an employee or an employee’s family members to compensate for losses caused by a qualified disaster must meet other requirements in order to be considered exempt from the self-dealing rule. First, the class of beneficiaries must be a “charitable class” (i.e. sufficiently large or indefinite). This requirement would bar payments from a disaster relief foundation if the foundation’s beneficiaries consist only of the employees of a small company. Secondly, the recipients must be selected based on an “objective determination of need,” and the selection must be made by an independent decision-maker or using procedures that can ensure that the employer does not receive any benefit that is greater than incidental or tenuous.
Employer-Funded or Employer-Facilitated “Crowd-Funded” Non-Exempt Relief Funds

An additional option for an employer wishing to provide or facilitate disaster relief to employees but unable or unwilling to meet the restrictions imposed upon private foundations is to provide relief to employees in the form of a payment from a fund that does not qualify as tax-exempt under Section 501(c)(3). Such contributions may come from the employer or from individual employees, and individual employee contributions may be matched by the employer. Contributions to such a fund, however, will usually not be tax deductible under Section 170.

Furthermore, the fund itself may incur income tax liability for contributions, particularly those contributions provided by employees themselves. The IRS has not yet provided definitive guidance as to the circumstances in which so-called “crowdfunding” contributions will be subject to taxation as income. Any proposed employee relief funding solution that does not qualify as either a private foundation or a public charity must therefore be analyzed under general income tax principles. Contributions to a fund may escape taxation as income by being classified as “gifts” under Section 102. However, the determination of whether or not a payment qualifies as a “gift” excluded from gross income is highly fact-specific and relates to the motivation of the donor. A gift made with the expectation of economic benefit may not be a “gift” for the purposes of Section 102. Since employees contributing to a non-501 (c)(3) disaster and hardship relief fund may do so with the expectation that they will receive economic assistance if they are affected by a disaster or hardship, and an employer contributing to such a fund may expect recruiting and employee retention benefits, it is not clear whether such contributions qualify as gifts.

Third-Party Public Charity Providers

Third-party public charity providers offer assistance to employers in creating and administering employee relief funds. One of the nation’s leading third-party providers is E4E Relief, which is headquartered in Charlotte, North Carolina, and serves companies across the United States. Such organizations may create a new fund for an employer or establish an employer-specific “field-of interest fund” within a larger charitable organization. Additionally, providers such as E4E Relief assist by providing recommendations regarding best practices and receiving and evaluating applications for relief from employees. Such organizations can increase the efficiency with which a fund operates and also help to ensure that selection of aid recipients is objective and anonymous. For more information on E4E Relief, please visit www.e4erelief.org.

Other Options for Providing Employee Relief

There are two additional options for providing disaster and hardship relief to employees. However, both may be impractical or inadvisable, depending on the circumstances and needs of the employer.

A public charity, like a private foundation, may provide assistance to employees in the event of a “qualified disaster.” Unlike a private foundation, a public charity may also provide assistance in the event of general economic hardship or a non-qualified disaster. The principal difficulty with establishing a public charity, however, is the requirement that a significant portion of its support be provided by the general public. Such an organization, then,
is achievable only for employers with a very large number of employees voluntarily contributing to the charity.

A voluntary employee’s beneficiary association is another type of tax-exempt organization that is authorized by the Internal Revenue Code to provide emergency and hardship assistance to employees. Although the organization’s fundraising is not subject to federal income tax, contributions by an employer are not tax-deductible to the same degree as contributions to a private foundation or a public charity. VEBAs, therefore, may not provide the most efficient means of administering disaster and hardship relief to employees.

**Conclusion**

Employers have several options for providing assistance to employees affected by disasters or other financial hardship. However, each solution outlined here either carries restrictions on the activities of the relief organization, imposes various requirements on the way in which funds are raised and administered, or subjects either the employer or the relief organization to potential income taxation.

Furthermore, it is important to note that any proposed employee relief program must be evaluated in light of applicable employment laws and any restrictions imposed by any collective bargaining agreements. Finally, please keep in mind that this article does not consider potential state tax issues and does not fully address whether distributions to an affected employee will be considered part of that employee’s taxable income. Additionally, there may be state and federal employment law restrictions on the ability of an employer to raise contributions for or make distributions from a fund to its employees.

1. A “foundation manager” is defined to include an officer, director or trustee of a foundation, and with respect to any particular act, the employee of the foundation having authority or responsibility related to that act. *I.R.C. 4946(b).*
2. *I.R.C. 4941(a).*
3. *I.R.C. 4941(b).*
4. *I.R.C. 4941(d)(1)(E).*
5. *I.R.C. 4946(a)(1).*
6. *I.R.C. 4946(a)(2); I.R.C. 507(d)(2); 26 CFR 1.507-6(b).*
7. 26 CFR 1.507-6(b).
8. See, e.g. IRS Private Letter Ruling 199917077 (1999) at 8 – 11. Although the Treasury Regulation 53.4941(d)-2(f)(2) clarifies that merely incidental or tenuous benefits to the disqualified person (such as public recognition) are not considered “indirect benefits” under the self-dealing rule, this ruling states that the benefits to an employer sponsoring a disaster and hardship relief fund are far more substantial.
9. See *I.R.C. 139.*
11. *I.R.C. 139(c).*
13. *Id.*
15. *Id.*