



Professional Perspective

Disaster Relief Payments: Tax-Efficient Assistance to Employees Impacted by Covid-19

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Disaster Relief Payments: Tax-Efficient Assistance to Employees Impacted by Covid-19

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Employers of all sizes are seeking to provide immediate financial assistance to employees impacted by the extraordinary coronavirus pandemic. Section 139 of the Internal Revenue Code provides a simple, tax-efficient method for employers to make non-taxable qualified disaster relief payments to employees for reasonable and necessary expenses resulting from the pandemic.

Payments made pursuant to Section 139 provide significant tax advantages for both employers and employees. For example, one client wanted to make immediate a \$15,000 payment to an employee quarantined with Covid-19 and a \$1,500 payment to each of approximately 50 employees who are impacted through telecommuting, increased childcare costs and modified home living conditions. The client anticipated that the total \$90,000 payment (approximately \$97,000 when including the employer portion of FICA and state unemployment taxes) would be treated as taxable wages reported on Forms W-2 with the employees receiving a net payment of approximately \$9,750 and \$975, respectively.

Imagine the client's surprise when it learned that, under Section 139, it could make a somewhat larger net payment to the affected group of employees (of \$10,000 and \$1,000, respectively) at a dramatically reduced cost of only \$65,000, rather than \$97,000. As an added benefit, Section 139 disaster relief payments have a substantially reduced administrative burden since the payments are not reportable on either a Form W-2 or a Form 1099-MISC.

Background

Generally, payments made by an employer to, or for the benefit of, an employee must be included in the employee's gross income under Code Section 61 and cannot be treated as a nontaxable gift under Code Section 102(c). Prior to the enactment of Section 139, various types of disaster payments made to individuals have been excluded from gross income under a general welfare principle, but no specific statutory exclusion was available for disaster payments from employers to employees.

Section 139 was enacted in the aftermath of the September 11 terrorist attacks. Fortunately, it is a little-used provision since it is only applicable when a qualified disaster occurs. When triggered, it overrides the broad income inclusion principles of Section 61 and allows employers to provide direct financial assistance to employees impacted by a qualified disaster without adverse tax consequences.

More specifically, qualified disaster relief payments are not treated as taxable income/wages for the employees, and the employer is able to deduct those payments as ordinary and necessary business expenses. Significantly, no dollar limit is placed on how much an employer may pay its employees on a tax-free basis. Instead the reimbursable expenses associated with the disaster must be "reasonable and necessary" and not "compensated for by insurance or otherwise."

Although Section 139's tax-favored attributes and requirements are easily administered and fairly straightforward, any employer considering making a qualified disaster relief payment should address certain additional questions as outlined below.

Defining a Qualified Disaster

Most advisers understandably focus on Section 139's application to losses incurred as a result of terrorist attacks and natural disasters such as hurricanes, tornadoes, wildfires, and flooding. However, Section 139(c)'s gatekeeping requirements are actually much broader and were triggered on March 13, 2020, when President Donald Trump declared a national emergency under the Robert T. Stafford Disaster Relief and Emergency Assistance Act due to the spread of the coronavirus. This National Declaration opens up an important employer-provided benefit that allows employers to provide tax-favored financial assistance to employees who are affected, directly or indirectly, by the coronavirus.

Reimbursable Expenses

In a natural disaster, reasonable reimbursable expenses typically relate to repairing and rebuilding housing, temporary housing and personal living expenses. Likewise, reimbursable expenses or in-kind payments associated with COVID-19

must be reasonable, necessary, and incurred as a result of Covid-19. As such, these will likely take many different forms including but not limited to, the following:

- Unreimbursed medical expenses including co-pays, deductibles, vitamins, and supplements
- Increased expenses associated with being quarantined at home (e.g., increased utilities and home office expenses, as discussed below)
- Expenses associated with setting up or maintaining a home office such as enhanced internet connections, computer monitors, laptops, printers, office supplies, etc. (even if such expenses would not otherwise satisfy the home office deduction requirements)
- Housing for additional family members, (e.g., transportation and living expenses for college students returning home including duplicative meal expenses)
- Nonperishable food purchases/reserves
- Increased childcare expenses
- Expenses to enhance mental health and physical well-being from social distancing such as meditation apps and home health fitness
- Alternative commuting means in lieu of mass transit

Nonreimbursable Expenses

Three broad categories of nonreimbursable expenses are:

- Payments for expenses that are not reasonable and necessary
- Payments that constitute an income replacement program (i.e., a payment for lost wages, lost business income or unemployment benefits)
- Payments that are reimbursed or reimbursable by insurance or otherwise

No Expense Substantiation

The employee is not required to provide the employer substantiation for expenses covered by Section 139. Due to the extraordinary circumstances surrounding a qualified disaster, employees are not required to account for actual expenses in order to qualify for the exclusion, provided that the amount of the payments can be reasonably expected to be commensurate with the expenses incurred.

Although substantiation is not required, a simple application/attestation statement from the employee is recommended to provide the employer with some protection under Section 139. Significantly, the reasonable belief provisions found in Subtitle C of the Code do not apply to Section 139 payments; however, Section 139's reasonableness provisions and the lack of a substantiation requirement have much the same effect as the reasonable belief provisions.

No Dollar Limit

Code Section 139 does not impose a dollar limit. An employer could provide an affected employee with a six-figure payment as long as the expenses in question are reasonable and necessary with respect to COVID-19. As a theoretical matter, this could include payments to reimburse an employee for the cost of installing and operating home-based healthcare equipment if there are no local hospitals or such hospitals are operating at capacity.

No Discrimination Testing

Payments are not subject to discrimination testing. Unlike various Section 132 provisions, Section 139 does not impose any discrimination rules under Section 139. However, Code Section 139(h) denies "double benefits" with the likely result that self-employed individuals and other owner-employees may find their tax deductions limited if they are actually a recipient of a qualified disaster relief payment.

No Payroll Taxes or Reporting

Qualified disaster relief payments are not subject to payroll taxes and information reporting. They are excluded from gross income and wages for payroll tax purposes. In addition to being exempt from payroll taxes, qualified disaster relief payments are not subject to information reporting on either Forms W-2 or Forms 1099-MISC.

No Deduction Limitations

Qualified disaster relief payments should be fully deductible. Even though the payments are neither taxable wages nor gross income, employers may reasonably take the position that the payments remain fully deductible to the same extent that they would have been if they were otherwise included in gross income or taxable wages. However, the recipients of such payments (e.g., a recipient who is an owner-employee or self-employed) are prohibited from taking a deduction to the extent that the payment was excludable from his or her gross income.

Cash Advances and Reimbursements

Although some tax advisers believe that qualified tax relief payments only apply to reimbursements, the better position is that Section 139 also encompasses cash advances to pay for covered expenses that the employer reasonably expects the employee to incur.

Section 132 Fringe Benefit Rules

Section 139 should override the provisions of Section 132 (regarding fringe benefits) to the extent that the provisions might otherwise cover the same payment.

Plan Documentation

Qualified disaster relief payments do not need to be paid pursuant to a plan document. In fact, a formal written plan document is not required or recommended. Nevertheless, given the benefits of tax-free status for qualified disaster relief payments, employers that choose to provide such payments should consider adopting an administrative system that validates such payments meet the Section 139 requirements. Such a system can include a short application form for assistance that validates the disaster for which relief is sought, contains an affirmative statement from the employee that the requested funds are necessary for expenses associated with Covid-19, and confirms that such expenses are not reimbursable by insurance.

Audit Outlook

The IRS is not likely to audit a program that clearly limits payments to reasonable and necessary payments incurred as a result of Covid-19. The audit team that would be involved with this type of issue would typically be an employment tax agent. These auditors are generally well-trained, fair, and even-handed in the approach that they maintain on issues involving equitable matters, especially where those positions have underlying statutory and factual support. Similarly, although the vast majority of states follow the federal exclusion by defining state taxable income with reference to an individual's federal taxable income, in the handful of states where a technical reporting requirement may exist for qualified disaster relief payments, we have not encountered any adverse audits that refuse to extend the same treatment at the state level.

Summary

Section 139 qualified disaster relief payments may be the most generous and easily administered of the various employee benefits provisions found in the Internal Revenue Code. In addition to some of the most favorable income and employment tax treatment of any provision of the Code, the reasonableness provisions, the broad nature of reimbursable expenses and the lack of any onerous substantiation requirement necessarily make Section 139 payments the first benefit that any employer should examine when trying to respond to the adverse financial impact that Covid-19 has on its employees. Due to the very favorable terms, it is easy to understand why Congress only allows it to be available under very limited disaster situations such as that currently posed by Covid-19.