

# Taking Care of Employees During COVID-19: Consider This Handy Employee Benefit Tool

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The coronavirus (COVID-19) pandemic, and our government's responses to the pandemic (such as shelter-in-place orders and other mobility restrictions), have dramatically changed the nature of our work environments. Companies are doing their best to mitigate the economic impact of the pandemic, while also evaluating possible options to support and engage their workforces during these difficult times. As employees across the country adjust to the new working norm, many have incurred additional expenses in the process, such as costs associated with setting up a home office as a result of being required to work from home. Now, as states start to lift lockdown orders and businesses start to reopen, employees who return to work may face new additional expenses in areas such as transportation (if mass transit remains closed, operates on a reduced schedule or is still deemed unsafe) and childcare (if schools remain closed or switch to remote learning only and camps and other childcare do not begin).

As companies move forward with their pandemic-response strategies, some may consider ways to help employees cope with the additional expenses stemming from the COVID-19 pandemic. For these companies, Section 139 of the Internal Revenue Code (Section 139) may prove to be a useful tool.

Enacted in the wake of the September 11 terrorist attacks, Section 139 offers a tax-efficient way for companies to provide financial assistance to employees affected by a disaster. This memorandum summarizes the rules underlying Section 139 and addresses certain questions that companies may have as they make (or consider making) payments to employees under Section 139.

## 1. What is Section 139?

Generally, Section 139 allows companies and other persons to make payments (known as "qualified disaster relief payments") on a tax-free basis to, or for the benefit of, employees affected by a federally declared disaster. Absent Section 139, any payment provided by a company to an employee would be included as gross income to the employee, unless the payment qualifies for another exclusion under the Internal Revenue Code, such as a working condition fringe benefit.

The statute was enacted to permit acts of charity to people in need caused by a disaster. As an example, if a person was hospitalized or lost his/her home in connection with a qualified disaster, that person's employer, or other members of the community, could pay for hospital bills or home repairs without the person incurring taxable income.

Qualified disaster relief payments under Section 139 include, among other things, any reimbursement or payment of reasonable and necessary personal, family, living or funeral expenses incurred as a result of a qualified disaster.<sup>1</sup>

## 2. Does the COVID-19 pandemic qualify as a disaster, triggering Section 139 relief?

**Yes.** On March 13, 2020, President Trump issued an [emergency declaration](#) for the ongoing COVID-19 pandemic under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. As a federally declared disaster, the COVID-19 pandemic constitutes a qualified disaster for purposes of Section 139. The IRS also [confirmed](#) that the COVID-19 pandemic qualifies for relief under Section 139.

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<sup>1</sup> Qualified disaster relief payments also include other types of payments, such as reimbursement of expenses relating to the repair or rehabilitation of a personal residence or its contents and payments made by a common carrier on account of death or personal physical injury, which are more applicable to natural disasters and terrorist acts than to a pandemic.

### 3. What types of expenses can a company reimburse or pay for under Section 139?

Generally, qualified disaster relief payments under Section 139 can be for the reimbursement or direct payment of any “reasonable and necessary” expenses incurred by employees as a result of the COVID-19 pandemic, whether or not the expenses were incurred in relation to work. While the IRS has not issued specific guidance on what might constitute “reasonable and necessary” expenses in a pandemic, some potential expenses covered by Section 139 in the current COVID-19 environment include:

- Costs associated with establishing a home office (e.g., appropriate computing, printing and phone equipment and accessories) and increased costs associated with maintaining a home office (e.g., increased internet costs and utility costs);
- Medical expenses related to COVID-19 and not covered by insurance, such as co-pays, deductibles and prescription drug costs;
- Dependent care expenses incurred due to closure of existing care providers, such as schools, daycares and camps;
- Costs associated with alternative forms of commuting due to mass transit being unavailable, impractical or unsafe;
- Costs to purchase personal protective equipment (PPE), such as face coverings and gloves;
- Housing costs incurred as a result of isolation or quarantine arrangements; and
- Funeral expenses (of employees or their family members who pass away due to COVID-19).

### 4. What types of payments are not eligible for relief under Section 139?

While Section 139 provides a flexible way to pay or reimburse employees for a wide variety of COVID-19-related expenses, companies should note that Section 139 will not cover the following types of payments:

- Payments that are intended to replace wages or compensation (e.g., qualified sick leave wages and qualified family leave wages under the Families First Coronavirus Response Act<sup>2</sup>);
- Payments for expenses that are not considered reasonable or necessary (e.g., excessive or non-essential expenses); and
- Payments that are reimbursed or compensated for by insurance.

### 5. Will payments under Section 139 be subject to federal income tax?

**No.** Qualified disaster relief payments disbursed to employees under Section 139 are not included in the employee’s gross income and are thus not subject to federal income tax. Further, they are not subject to payroll taxes under the Federal Insurance Contributions Act (FICA) or the Federal Unemployment Tax Act (FUTA), and are not reportable on Form W-2 or Form 1099.

### 6. Will payments under Section 139 be subject to state income tax?

**It depends.** While each state’s tax system is different, many states that impose taxes on an individual’s income will not include Section 139 payments as gross income.

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<sup>2</sup> For more information on the Families First Coronavirus Response Act (FFCRA), please see our previously published [client memorandum](#).

By way of examples:

- **New York**, with certain exceptions, generally follows the federal tax rules in calculating adjusted gross income for state income tax purposes. If a payment represents a qualified disaster relief payment under federal law, and thus would not be included in a recipient's adjusted gross income for federal income tax purposes, New York will recognize such payment as a qualified disaster relief payment as well and the recipient will not be required to include it in his or her adjusted gross income for state income tax purposes.
- **California recognizes** Section 139 treatment for qualified disaster relief payments made by employers. Such payments will not be subject to the California personal income tax withholding and will not be reported as income in the recipient's adjusted gross income for state income tax purposes; however, they will be subject to California unemployment insurance, employment training tax and state disability insurance (which includes paid family leave), unless otherwise excluded under the California Unemployment Insurance Code as a payment resulting from the death of an employee.

Before providing any qualified disaster relief payments, companies should consider the state, local or other non-federal tax implications and consult with a local tax specialist. In some states, such payments may be subject to state unemployment tax even if they are not subject to state income tax.

## **7. Will companies be able to deduct payments made under Section 139?**

**Yes.** While qualified disaster relief payments will not be considered gross income to the receiving employee, such payments will be fully deductible by the employer, and, as such, they offer the best of both worlds for employees and employers from a tax perspective.

## **8. Is there a limit to the amount of assistance companies may provide to employees under Section 139?**

**No.** There is no maximum dollar amount for qualified disaster relief payments that a company may provide under Section 139. However, for business and budgetary reasons, companies may wish to impose internal limits on the types and amounts of COVID-19-related expenses that may be paid for or reimbursed.

## **9. Are there coverage and non-discrimination requirements under Section 139?**

**No.** Unlike some other employee benefits, which must satisfy certain coverage and non-discrimination requirements in order to qualify for favorable tax treatment, payments under Section 139 are not subject to such requirements.

## **10. How does Section 139 relate to Section 132 of the Internal Revenue Code, which provides that certain fringe benefits are not includable in an employee's gross income?**

Section 139 represents a broader, more flexible approach to providing benefits to employees than Section 132. For example, whereas Section 132 requires discrimination testing for certain fringe benefits and covers a relatively narrow universe of expenses, Section 139 does not require any discrimination testing and covers a broader range of expenses. Generally, in the event Section 139 and Section 132 would both cover the same type of payment, it would likely be easier for the company and the employee to rely on Section 139.

## **11. May companies provide assistance to other service providers, such as directors, consultants and other independent contractors, under Section 139?**

**Yes.** Section 139 treatment applies to qualified disaster relief payments made to any individual regardless of his or her relationship with the payer. Thus, companies may provide reimbursements and/or direct payments to any of their service providers, including their employees, directors, consultants and other independent contractors, under Section 139.

## 12. Are there any administrative or substantiation requirements that an individual must satisfy in order to receive qualified disaster relief payments?

**Generally, no.** The IRS has previously **issued guidance** that, due to the circumstances surrounding a disaster, there is no need for individuals to account for actual expenses in order to qualify for the Section 139 exclusion, provided that the amount of the qualified disaster relief payments can be reasonably expected to be commensurate with the expenses incurred. Thus, the IRS does not require individuals to account for such expenses.

However, the COVID-19 pandemic represents a unique qualified disaster that may challenge our current understanding of Section 139 relief. Typically, a qualified disaster would take the form of a natural or man-made disaster of limited duration, such as a flood as contemplated in the IRS guidance or a terrorist attack that prompted the enactment of Section 139. The COVID-19 pandemic will likely be longer-lasting and may involve expenses of a magnitude not previously contemplated. Thus, best practices may be to account for expenses to the extent practicable, in case their qualification under Section 139 is questioned by the IRS in the future. In addition, companies may wish to consider requesting documentation substantiating Section 139-related payments to ensure that expenses are reasonable and necessary and have been incurred as a result of COVID-19 (as further discussed in Question 13 below).

## 13. Are there any administrative or substantiation requirements that a company must satisfy in order to provide qualified disaster relief payments?

**Generally, no.** Just as individuals are not subject to any substantiation requirements to demonstrate that an applicable payment qualified as a qualified disaster relief payment, companies are similarly not required to provide substantiation for such amount. However, considering the wide range of expenses that can be incurred in the COVID-19 pandemic and the magnitude of such expenses, companies may wish to adopt a written program or policy that specifies the types and amounts of expenses that can be paid for or reimbursed as qualified disaster relief payments, as well as receipts and other evidence that individuals would be required to submit before receiving payments or reimbursements. This would help companies control the cost of providing payments under Section 139, and would also make it easier for companies to administer and communicate this benefit. It would also provide a structure and audit trail, to the extent this is required later by the company's accountants or the IRS.

## 14. Has the COVID-19 pandemic prompted Congress to consider changes to Section 139?

**Preliminarily, yes.** The Health and Economic Recovery Omnibus Emergency Solutions Act (also known as the HEROES Act), which the House of Representatives **passed** last month, includes a new refundable payroll tax credit for employers that works in tandem with Section 139. Under the bill, for each calendar quarter, employers would be allowed a tax credit equal to a percentage of "qualified pandemic-related employee benefit expenses" paid by the employer.<sup>3</sup> "Qualified pandemic-related employee benefit expenses" would include any amount excludible from the employee's gross income by virtue of being qualified disaster relief payments under Section 139, with such amount capped at \$5,000 per employee per calendar quarter. The tax credit would apply against the employer portion of the federal social security tax under FICA.

Unlike the tax treatment under Section 139, the proposed new tax credit is conditioned on meeting non-discrimination requirements and employers would not be allowed to take the tax credit if the qualified pandemic-related employee benefit expenses are provided to employees in a manner that discriminates in favor of highly compensated employees (within the meaning of Section 125 of the Internal Revenue Code). In addition, to prevent duplication of tax benefits, no deduction or credit (other than the proposed tax credit) would be allowed for qualified pandemic-related employee benefit expenses. However, by

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<sup>3</sup> The percentage would be 50% in the case of qualified pandemic-related employee benefit expenses paid for the benefit of employees who perform "essential work" and 30% for payments with respect to all other employees.

permitting the employer to elect how such expenses are to be treated, the employer would be able to choose whether to use the tax credit or retain its deduction.

The proposed tax credit under the HEROES Act could provide an additional incentive for companies to provide financial assistance to employees under Section 139, but, as of the date of this memorandum, the future of the HEROES Act looks bleak as both the President and the Senate have stated that they would not consider the bill in its current form. It remains to be seen whether the proposed tax credit (or some variation of it) would be included in the next phase of the COVID-19 relief legislation.

## In Conclusion

As the COVID-19 pandemic continues to disrupt the ways in which employees provide services to companies, companies may wish to consider tools to help employees adjust to new work environments and maintain morale and motivation during these challenging times. Section 139 provides an additional tool companies might consider to provide resources to employees of all levels as they begin the transition back to work under stringent health restrictions or cope with the reality of working from home for the longer term. The unrestrictive nature of Section 139 gives companies the flexibility to craft their own program and set their own parameters, and the existing and potential future tax benefits of Section 139 payments should also help reduce the effective cost of such program. Deployed effectively, Section 139 could be a win for both employers and employees.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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