Cooley

Employers Have an Opportunity to Provide Tax-Free Reimbursements and Payments to Employees

April 2, 2020

On March 13, 2020, the president declared the COVID-19 pandemic a national emergency that warrants assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act (the Stafford Act). That declaration permits employers to provide tax-free payments to their employees impacted by COVID-19 under Internal Revenue Code section 139. However, absent guidance from the IRS, employers should use caution when implementing programs designed to qualify for income tax exclusion under section 139.

Overview of section 139

Section 139 excludes from gross income "qualified disaster relief payments" received by individuals. Employees may exclude qualifying section 139 payments from gross income for federal income tax purposes, and employers may take a corresponding income tax deduction. Generally, qualified disaster relief payments include amounts 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 to the extent the expense is not compensated for by insurance or otherwise. A qualified disaster includes a federally declared disaster, which is defined as a disaster subsequently determined by the president to warrant assistance by the federal government under the Stafford Act and includes the COVID-19 pandemic.

Limitations

There is no specified dollar limitation on the amount of payments that may be excluded from income for federal income tax purposes by operation of section 139. However, the payment cannot be in the nature of income replacement, such as a payment for lost wages or unemployment compensation. Moreover, the amount of the payment should be commensurate with the expenses for which the payment is being made. The limitation on income replacement will make it difficult, in the absence of guidance from the IRS to the contrary, for severance payments to qualify for exemption from federal income taxation under section 139.

Expenses that potentially qualify

The IRS has yet to issue guidance on the types of payments that qualify for income exclusion for federal income tax purposes under section 139 in the context of a pandemic such as COVID-19. Expenses that potentially qualify for exemption under section 139, assuming they are not compensated for by insurance or otherwise and are reasonable and necessary, include:

- Medical and other health-related expenses relating to COVID-19, such as co-payments for doctor's visits and costs for over-the-counter medications
- Increased expenses relating to childcare and home schooling that are reasonable and necessary as a result of school and daycare closures
- Expenses associated with working from home as a result of the pandemic
- Transportation expenses incurred as a result of COVID-19, such as expenses incurred to avoid the use of mass transit
- Expenses incurred for a hotel room due to quarantine
- Funeral expenses for an employee or a family member who dies from COVID-19

Written policy

Section 139 does not require employers to maintain a written policy for disaster relief payments. Nonetheless, employers should consider maintaining a written policy that sets forth the parameters of the program, including the types of expenses that are eligible for reimbursement and payment under the program, any limitations on amounts that will be paid under the program, any administrative requirements of the program, and the duration of the program.

Employee receipts

Section 139 does not require employees to account for the actual expenses in order to qualify for the exclusion, provided the amount of the payments is reasonably expected to be commensurate with the expenses incurred. Employers should consider requiring an accounting of expenses in order to manage costs of the program, avoid abuse and limit any potential tax exposure for the employer.

Employment tax considerations

Section 139 payments are not considered wages for federal tax purposes, and therefore, are not subject to federal income tax withholding or FICA taxes. If the IRS were to challenge an employer's treatment of a payment as qualifying for exemption under section 139, the employer could be liable for not only its share of FICA taxes, but also for the income and FICA taxes the employer was required to withhold from the employee.

This content is provided for general informational purposes only, and your access or use of the content does not create an attorney-client relationship between you or your organization and Cooley LLP, Cooley (UK) LLP, or any other affiliated practice or entity (collectively referred to as "Cooley"). By accessing this content, you agree that the information provided does not constitute legal or other professional advice. This content is not a substitute for obtaining legal advice from a qualified attorney licensed in your jurisdiction, and you should not act or refrain from acting based on this content. This content may be changed without notice. It is not guaranteed to be complete, correct or up to date, and it may not reflect the most current legal developments. Prior results do not guarantee a similar outcome. Do not send any confidential information to Cooley, as we do not have any duty to keep any information you provide to us confidential. When advising companies, our attorney-client relationship is with the company, not with any individual. This content may have been generated with the assistance of artificial intelligence (AI) in accordance with our AI Principles, may be considered Attorney Advertising and is subject to our legal notices.

Key Contacts

Alessandra Murata Palo Alto	amurata@cooley.com + 1 650 843 5696

This information is a general description of the law; it is not intended to provide specific legal advice nor is it intended to create an attorney-client relationship with Cooley LLP. Before taking any action on this information you should seek professional counsel.

Copyright © 2023 Cooley LLP, 3175 Hanover Street, Palo Alto, CA 94304; Cooley (UK) LLP, 22 Bishopsgate, London, UK EC2N 4BQ. Permission is granted to make and redistribute, without charge, copies of this entire document provided that such copies are complete and unaltered and identify Cooley LLP as the author. All other rights reserved.