GIBSON DUNN

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TAX-FAVORED FINANCIAL AND OTHER ASSISTANCE TO EMPLOYEES IN THE FACE OF COVID-19

To Our Clients and Friends:

The COVID-19 pandemic has been extremely challenging for everyone, changing day-to-day life in unprecedented ways. On March 13, 2020, President Trump declared a national emergency under the Robert T. Stafford Disaster Relief and Emergency Assistance Act (the "Act"). Many employers have been providing assistance to employees whose working schedules have been reduced or who have been temporarily laid off by continuing some or all of their pay for a period of time. Payments in the form of salary or wage continuation, while certainly welcome, are treated as taxable income to the employee. However, the President's national emergency declaration under the Act gives employers a means to provide tax-free financial assistance to employees who are affected, directly or indirectly, by COVID-19, while preserving the employer's ability to deduct the payments of financial assistance.

Section 139 ("Section 139") of the United States Internal Revenue Code (the "Code") provides, in relevant part, that "Gross income shall **not** include any amount received by an individual as a qualified disaster relief payment". 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". Section 139 applies to both federal income and employment taxes. With the President's declaration of a national emergency, the COVID-19 pandemic is a "qualified disaster".

Given the likely significant financial burdens that many employees will bear as a result of quarantines and/or limited or ceased business operations in the coming days and weeks, employers who are able may want to consider providing tax-favored financial assistance to affected employees. As noted, this form of financial assistance will not be treated as taxable wages/income to the employee. Furthermore, it should be fully deductible to the employer as a business expense.

- *Employers May Provide Non-Taxable Financial Assistance Directly.*

  Under Section 139, employers may provide direct financial assistance to employees affected by COVID-19. The assistance provided will not be treated as income/wages to the employees, and the employer should be able to deduct those payments as business expenses. There is no ceiling on the amount of assistance that may be provided to an employee under Section 139 other than it must be "reasonable and necessary" and must not be for an expense reimbursable by the employee's insurance. This means that employers cannot provide across-the-board assistance to all employees or group of employees under Section 139. Rather, the employer will need to set up a process for accepting and evaluating applications for financial assistance. The employer should

also ensure that its payroll function treats any such payments as separate from wages so that the amounts paid are not inadvertently characterized as taxable to the recipients. There are no requirements to report qualified disaster relief payments to the Internal Revenue Service ("IRS").

Other forms of assistance that may be provided to employees who incur a financial hardship as a result of COVID-19 include:

- *Employees Helping Employees: Employee Leave Transfer Programs.*

  An employer may establish an employee leave transfer program. An employee leave transfer program allows employees to help their co-workers by donating some of their available vacation, sick pay or PTO hours into a "leave bank" for the purpose of aiding affected colleagues who do not have enough paid time off to cover an extended break from their job. Employees affected by COVID-19 (or other medical emergencies) who have exhausted, or will exhaust, their paid leave due to the medical emergency may then withdraw additional leave from the leave bank. The paid time off used from the leave bank is taxable income to the employee who receives the additional leave. So long as the donated leave is used for another employee's "medical emergency", the employee donating the leave is **not** taxed on the value of the donated leave. A "medical emergency" is defined as "a medical condition of the employee or a family member that will require the prolonged absence of the employee from duty and will result in a substantial loss of income to the employee because the employee will have exhausted all paid leave available apart from the leave-sharing plan". Similar favorable tax treatment is also available for leave donation in the event of a "major disaster", but as of the date of this Alert, the technical requirements of that definition have not been satisfied by the COVID-19 pandemic. Employees can also contribute funds to aid fellow employees, but unless those funds are contributed to a charitable organization, such as one of those described below, the employee donating the funds will be treated as making a gift with after-tax income and will not be able to claim an income tax deduction.

- *Employer-Sponsored Charitable Organizations Classified as Public Charities.*

  Some employers have established tax-exempt charitable organizations under Section 501(c)(3) of the Code, one of the purposes of which may be to provide financial assistance to employees who face unexpected emergencies that have resulted in financial hardship. The type of financial assistance that may be provided by an employer-sponsored charity depends on how the charity is classified under the federal tax law regulating tax-exempt organizations. If the employer's charitable organization is classified by the IRS as a "public charity"--generally because it receives contributions from a sufficiently broad number of donors--then the organization may provide financial assistance to any employee who experiences a financial hardship on account of COVID-19. The employee with the financial need must apply for assistance, and the organization must determine the extent of its support based on the nature and size of the need. Proper procedures are important. If they are followed, any financial assistance provided by the organization should not be taxable to the recipient employee. And because the organization is

itself exempt from federal income taxation, it can apply all funds received (without the drag of income taxation) to achieve its charitable goals.

- *Employer-Sponsored Charitable Organizations Classified as Private Foundations May Provide Assistance Following the Declaration of a National Emergency without the Risk of Incurring Certain Tax Liabilities.*

  If an employer-sponsored charitable organization is classified as a Section 501(c)(3) "private foundation" as opposed to a public charity--generally because most or all of the funding is provided by the employer—then providing financial assistance to employees presents a number of risks to the organization under the Code. First, and most importantly, providing support to employees could be treated as advancing the employer's private interests and therefore risk the tax-qualified status of the organization. According to the IRS, a private foundation has to be "operated exclusively for exempt purposes". Second, such financial support might be treated as "self-dealing" on the part of the employer and subject the employer and the foundation manager to substantial excise taxes. However, when financial assistance is provided in connection with a "qualified disaster" (which follows the same basic definition as Section 139, and, therefore, would cover the COVID-19 pandemic), payments by the private foundation, if properly made and documented in the same manner as described above in the section covering public charities, should not threaten the tax-qualified status of the organization or constitute proscribed acts of self-dealing under Section 4941 of the Code, among other benefits. Furthermore, the organization would not need to seek prior approval from the IRS to provide this form of assistance to individuals, although if not otherwise covered in the description of its purposes, the organization would need to disclose this program in its next annual filing with the IRS.

  Note that if an employer is considering establishing a new private foundation to provide financial assistance to employees who suffer a financial hardship as a result of the COVID-19 pandemic, it will need to continue the foundation beyond the COVID-19 pandemic either to address other charitable purposes or to aid employees with future financial emergencies. The IRS requires that any tax-exempt charity serve a "charitable class" (which means that the covered group has to be "large or indefinite"), and, in the context of financial relief provided to employees by an employer-sponsored charitable organization, this requires at a minimum that the class of recipients be broadened to cover employees who incur financial hardships in the future. Furthermore, an independent person or group should be selected to make decisions regarding the delivery of aid to employees, as the IRS wants to see that "any benefit to the employer is incidental and tenuous".

- *Charitable Donations to a Donor-Advised Fund Administered by an Independent Public Charity.*

  An employer may not have previously established a charitable organization and does not wish to do so now. Some community foundations and public charities maintain separate funds or accounts to receive contributions from individual donors. These donors then receive advisory privileges over investment or distribution of the donated funds. While donor-advised funds generally may not make grants to individuals, an exception is made for funds or accounts

established specifically to benefit employees and their family members who are victims of a qualified disaster.

In order for the employer-sponsored donor-advised fund to be able to give directly to employees, the fund must meet the following criteria. First, the fund must serve the single identified purpose of providing relief from one or more qualified disasters. Second, it must serve a "broad and indefinite" charitable class. Third, the recipients of the donations must be selected based on an objective determination of need, and the selection must be made either by (i) using an independent person or group or (ii) establishing adequate substitute procedures to ensure that any benefit to the employer is incidental and tenuous. Fourth, no payment may be made from the fund to or for the benefit of any director, officer, or trustee of the sponsoring community foundation or public charity, or any person who is selecting recipients. Fifth, the fund must maintain adequate records to demonstrate the recipients' need for the disaster assistance provided.

- *Charitable Contributions to a Relief Fund Established by Another Organization.*

  An employer may make charitable contributions to a disaster relief fund established by an independent charitable or governmental organization under which the other organization makes the decisions regarding who will receive aid. While the employer would receive a charitable contribution for its contributions, it would have limited or no ability to influence the selection of recipients. Therefore this Alert focuses on those approaches that allow an employer to have greater levels of influence over the selection over who benefits from the employer's generosity.

Gibson Dunn's lawyers are available to assist with any questions, as detailed below.

In addition, the IRS has set up a page on its website to address matters relating to Coronavirus tax relief. See https://www.irs.gov/coronavirus.

Gibson Dunn's lawyers are available to assist with any questions you may have regarding the multitude of legal developments related to the COVID-19 pandemic. For additional information, please contact any member of the firm's ***Coronavirus (COVID-19) Response Team****.*

The following Gibson Dunn lawyers prepared this client update: Stephen Fackler and Allison Balick, with assistance from Dora Arash, Eric Sloan, Edward Wei, Jeffrey Trinklein and David Rubin. Gibson Dunn lawyers are working with many of our clients on their response to COVID-19 and are available to assist with questions about various types of employee assistance arrangements, including those that fall within the scope of Section 139. Please feel free to contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's ***Executive Compensation and Employee Benefits****,* ***Tax****, or other practice groups, or the authors:*

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