

Tax Treatment of Employee Hardship and Disaster Relief



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Recent hurricanes and fires have caused employers to focus on how to help employees who have been victims of disasters. Employees also suffer hardships that are not related to disasters, but that result from personal situations such as serious illness or death. There are a variety of ways that an employer can provide assistance to employees in these circumstances. In structuring this assistance, most parties prefer that the payments be tax-deductible to the employer but not constitute taxable income to the employee.

Employer Provides Assistance Directly

Under Section 139, disaster relief payments are not included in the recipient's income. These payments can be made by an employer to an employee. The rules are set forth in Section 139 as follows:

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- the disaster must be a qualified disaster
- the employee must be within the disaster area
- the payment must be of the type defined in the Internal Revenue Code.

A qualified disaster is one that:

- is a presidentially declared disaster (a disaster determined by the U.S. president to warrant assistance by the federal government)
- results from terrorist or military actions
- is deemed catastrophic by the Secretary of the Treasury.

Shortly after Hurricane Harvey, a federally declared disaster was announced for areas in Florida, Louisiana and Texas. Payments made to employees who resided in the counties listed under the federally declared disaster zone and that qualified as disaster relief payments would not be included in the employees' incomes.

A qualified disaster relief payment can be made:

- to reimburse or pay for reasonable and necessary personal, family, living or funeral expenses incurred as a result of a qualified disaster, including providing money, services or goods to ensure that the victims have the basic necessities, such as food, clothing, housing, transportation and medical care, regardless of their financial resources
- to pay for or reimburse reasonable and necessary expenses to repair or rehabilitate a personal residence or its contents, provided such actions are necessary as a result of a qualified disaster.

A qualified disaster payment made by an employer to an employee impacted by a qualified disaster is excluded from compensation and is not treated as net earnings

from self-employment. One significant restriction is that the payment cannot be for an item that is compensated by insurance or other means. For that reason, the employer should require that employees affirm that they do not have insurance that would cover expenses. An employer should ask an employee which types of insurance the employee has, whether the employee has contacted his or her insurance agent to determine what coverage is available, and whether items such as living expenses and transportation are covered under the insurance policy. An employer should keep records of all disaster aid. In particular, if the employer provides aid before an employee can determine insurance coverage, the employer should keep adequate records so it can report payments as taxable compensation if it is later determined that insurance coverage was available for amounts for which payments were made. Sometimes employees will not find out until months or even years after the disaster whether, and how much, their insurance will pay. Having evidence that the employer inquired about insurance coverage will facilitate tax-free treatment to the employee.

Providing Assistance Through an Employer-Sponsored Charitable Organization

Instead of providing relief directly, an employer can provide relief through a charitable organization. The organization must apply to the IRS for recognition as tax-exempt under Section 501(c)(3). Like all Section 501(c)(3) organizations, disaster relief organizations cannot confer a private benefit on an individual. If the employer controls the selection of recipients, the charity could be viewed as a means of helping the employer recruit and retain employees, resulting in an impermissible private benefit to the employer. Consequently, with an employer-sponsored charity, the employer cannot control which employees will receive aid. If the charity is making a qualified disaster payment, the criteria set forth above should be considered. However, the charity must show that the payments are not being made for the employer's benefit. This can be demonstrated in several ways.

First, the charity should *select recipients based on an objective determination of need*. In making this determination, it is not necessary that the recipient be completely destitute, and a person can be considered impoverished if the person lacks the resources to obtain the basic necessities or if the person is temporarily in need of food or shelter. A charity may provide crisis counseling, rescue services or emergency aid, such as blankets or hot meals, in the immediate aftermath of a disaster without the recipient needing to show financial need.

To ensure an objective determination of need, the charity should establish written criteria for employees' applications for relief, the criteria for making a selection, and the disbursement of funds. There also should be an objective evaluation of the victims' situations at the time the grants are made. Charities should also preserve documentation, including:

- description of assistance, including amount and type
- purpose for which it was given
- how the recipients were selected
- charity's criteria for disbursing assistance under the particular program
- name, address and position of recipient
- relationship between the recipient and the officers, directors or key employees of, and substantial contributors, to the charity
- composition of the selection committee
- all correspondence with applicant, particularly if assistance was denied, and a written record of all conversations.

Second, the charity should *ensure that a broad charitable class is served*. The class should include victims of current disasters and future disasters and should include current and future employees. This ensures that the class is indefinite.

Third, the charity should *create an independent selection committee*, in which a majority of the committee consists of individuals not in a position to exercise substantial influence over the employer's affairs. This is designed to ensure that any benefit to the employer is incidental.

Even if an existing charity was not specifically organized to provide disaster relief and disaster-related activities were not specified in its application for exempt status, the charity may engage in disaster relief activities without obtaining prior permission from the IRS. However, it must report this new activity on its annual tax return.

Employer-Sponsored Public Charity

An employer-sponsored public charity can be classified as either a public charity or a private foundation. If the employer solicits and receives contributions to the charity from employees or the general public, the charity can become a public charity. To ensure that it receives broad public support, the charity must meet specific tests relating to the source of its support. An employer-sponsored public charity has more flexibility than an employer-sponsored private foundation. An employer-sponsored public charity can provide relief to employees in any emergency or personal hardship situations, including serious illness, injury, fire, flood, natural disaster, military deployment, being a victim of a violent crime, death of an employee or dependents, or qualified disasters.

If all of the rules set forth above relating to an employee-sponsored charity are followed, payments made to a victim of a disaster or an emergency hardship by the employer-sponsored public charity are presumed to be made for a charitable purpose. As long as the charity is established to assist employees who are victims of all disasters, both present and future, the payments will be viewed as being made to an indefinite class. In that case, the payments should not be taxable compensation to the employees.

Employer-Sponsored Private Foundation

If the employer-sponsored charity does not solicit contributions, and the employer is the sole contributor, then the charity will be a private foundation. A private foundation is more limited in the assistance that it can provide because a private foundation is potentially subject to the excise tax on self-dealing. Unlike an employer-sponsored public charity, an employer-sponsored private foundation can only provide support in response to a qualified disaster. It cannot make payments to individuals in an emergency situation like a house fire or severe illness of an employee's child. In addition, an employer-sponsored private foundation must avoid self-dealing. An assistance payment made to a member of the selection committee or an officer or director (or one of their family members) of the foundation would be considered self-dealing.

Gifts of Cash or Property by Employees to Other Employees

In addition to providing or facilitating assistance from a charity, an employer may wish to help its employees give to their fellow employees who are the victims of a disaster or personal hardship. If an employee gives funds or property to a fellow employee, the transfer should be treated as a gift for tax purposes. The donor has no consequences unless the gift exceeds the annual exclusion amount (\$14,000 in 2017, \$15,000 in 2018), and the recipient pays no tax on the receipt of a gift.

If an employer facilitates gifts between employees, the employer needs to separate those gifts from any amounts provided by the employer. Gifts from an employer (other than those covered by Section 139) are treated as taxable income. If an employer merely helps employee-to-employee gifts, but makes no contributions, the payment should be respected as a gift. If an employer's role is to help set up a bank account or other mechanism to collect the funds, the employer should be treated as acting as agent for the employees. Its role should be limited to collecting the payments and providing them to the recipients selected by the employees who contributed.

Pepper Perspective

Given the volume of disasters this year, many employers may want to help employees and their families obtain basic necessities during the initial recovery stages. To provide this assistance tax-free to employees, the employer must navigate the detailed maze of provisions governing assistance programs. In addition, employers may want to help employees deal with personal emergencies by providing assistance directly or through a charitable organization. In all circumstances, it is crucial that the program be documented, including identifying who is eligible, how a particular employee satisfies the eligibility criteria, whether they have insurance to cover any of the types of losses that the employer is planning to fund, and who is on the selection committee. Creating or using a charitable organization requires compliance with the rules governing these organizations if the parties intend for the payments to be tax-free to the recipients as well as deductible to the employer.