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An Employer's Guide to Providing Financial Assistance to Employees in Response to the COVID-19 Pandemic

As we continue to deal with the numerous challenges of the COVID-19 pandemic, we have been receiving questions from companies as well as private equity sponsors asking how they can help employees. Below is a brief overview of strategies for providing financial assistance to employees affected by the COVID-19 pandemic, including tax consequences.

Direct Payments and Benefits to Employees

There are a number of strategies that employers can adopt to provide financial assistance to employees.

Qualified Disaster Relief Payments

Payments by an employer to its employees are generally taxable to the employee as compensation. However, an exception to this rule is for qualified disaster relief payments (QDRPs), which employers may make to employees on a tax-free basis. To qualify as a QDRP, the payment must be to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster,[1] the payment cannot be for expenses that were compensated for by insurance or otherwise, and reasonable substantiation of the expenses must be provided (this does not require actual substantiation, and may be shown if the employer reasonably expects the payments to be commensurate with the amount of employees' reasonable and necessary expenses). While there has been no official IRS pronouncement that the COVID-19 pandemic is a qualified disaster for QDRP purposes, the pandemic should meet the definition of qualified disaster in the tax code because it is a federally-declared emergency.

Unlike in the context of a natural disaster such as a hurricane or fire, it is less clear what expenses might be considered to be "incurred as a result of" the COVID-19 pandemic for QDRP purposes. Presumably any expenses incurred due to employees' efforts related to containing the spread of the virus could potentially qualify. However, the legislative history indicates that QDRPs will not include payments in the nature of income replacement, such as lost wages.

An employer who makes QDRPs to employees may deduct those payments as if they were includible in employees' taxable income.

While funding (by employees or others, such as sponsors) could be provided to an employer to enable it to make QDRPs to employees, those providing such funding would not receive a charitable contribution deduction.

[1] QDRPs also can be used for repair of personal residence or replacement of contents resulting from a qualified disaster (such as a fire or hurricane).

Loans

Bona fide loans extended by employers to employees to cover expenses in times of need do not generally result in taxable income to employees. The structure of an employee loan needs to be considered carefully to determine whether any taxable compensation may result, and at what time – e.g., in general, a bona fide loan must accrue interest at least equal to the applicable federal rate and must not be forgivable on its face.

Bonuses and Other Cash Payments

Employers may wish to pay a one-time bonus to employees to provide additional support during the COVID-19 pandemic. Unless structured as QDRPs, such payments (including payments in respect of lost wages) will result in taxable income to employees. Employers who wish to make such a payment tax neutral to employees may consider providing a tax gross up.

Employee-to-Employee Giving

An employer may choose to facilitate employees' gifts to one another by pooling those gifts in a separate bank account and paying the gift amounts to employees separate from any QDRPs. Under those circumstances, the employer is likely considered an agent for the employee-donors (i.e., not the payor), such that the employee-recipients of their colleagues' contributions would be considered to have received personal non-taxable gifts. It is important to note that these payments, as gifts to individuals, would not be deductible as charitable contributions, and could subject the employee-donor to gift tax.

Providing Additional Health Care Benefits and Paid Time Off

Employees are concerned about medical coverage to deal with the consequences of the pandemic. While ordinarily an employer pays the full cost of employee life and disability coverage, an employer may increase its contribution to subsidize health insurance premiums for medical, dental, and vision care. This can be done with no additional tax impact for the employee and is deductible by the employer, as long as providing the additional subsidy covers a broad-based group of employees (not just the highly paid).

If employees are terminated from employment or furloughed (i.e., temporarily laid off) as a result of the COVID-19 pandemic, and are not eligible to continue to participate in their employer's health plans other than through COBRA, they may fear losing medical coverage if they cannot afford pay to the cost of COBRA premiums. An employer may continue to provide employer-paid health care for a period following termination or furlough. Some employers are doing this for 2-3 months. This can be done with no additional tax impact for the employee and is deductible by the employer, as long as the extension is broad based.

Employers may also determine to increase paid time off benefits provided to their employees, although such paid time off will result in taxable income to employees when taken (and, such paid time off will be in addition to any paid leave to which employees may be entitled under the Family First Coronavirus Response Act, which applies generally to employers with fewer than 500 employees).

Access to 401(k) Plan Accounts

In many instances, the employer itself may have cash flow issues as a result of the COVID-19 pandemic and may not have sufficient funds to provide cash incentives or subsidies to employees or former employees. Although the 401(k) plan is intended for retirement, there are strategies available to both the employer and the employee.

1. Matching Contributions. Unless the employer has adopted a safe harbor contribution formula, the employer can amend the plan to reduce or eliminate the matching contribution (this was a common strategy following the 2008/9 Financial Crisis). In addition, even in the case of a safe harbor plan, there are two bases on which the safe harbor formula can be amended to reduce or eliminate the contribution: (1) if the employer is operating at an "economic loss"; or (2) if the safe harbor notice provided to the participants reserved the right to change the safe harbor during the year. The reduction in the safe harbor matching contribution is not effective until 30 days after notice is provided to the participants (or if later, the date of the Board vote). The funds that are freed up from employer matching contributions can be used for other purposes, including to pay wages or make "qualified disaster relief" payments described above.

2. Reduction in Employee Deferrals. The first thing that an employee will consider when income is reduced is a reduction in the employee's contribution to the plan. Employers should work with their record keepers to make sure that any changes are processed promptly.

3. Plan Loans. Participants are generally permitted to borrow up to 50% of their account balances, but not more than $50,000. The loan needs to be repaid by payroll deduction over a period not to exceed 5 years (except certain mortgage loans). If the loan is not repaid, it becomes taxable income to the participant. Generally, upon employment termination the loan needs to be repaid in full, and if not repaid, the loan goes into default and the outstanding balance becomes taxable income to the participant (though the plan administrator may adopt a rule that does not put the loan into default until the end of the calendar quarter following the calendar quarter in which the loan repayment is missed). However, if the employee is furloughed, the tax rules do not require repayment for up to 1 year, except that once the employee returns to work, the repayment still must be made over the original 5 year period (the loan is reamortized over the shorter period). In addition, the employer can work with the record keeper to allow participants to repay the loan following termination of employment, though this strategy will work only to the extent that the former employee has income from which to repay the loan.

4. Plan Hardship Distributions. Most 401(k) plans have a provision that allows participants to take in-service distributions of their own elective contributions for "hardship distributions." The amount distributable has to be due to "immediate and heavy financial need" and can only be to the "extent necessary" to meet that need. The plan may adopt a safe harbor definition of what is permitted for hardship, and that generally includes medical expenses, and the amount necessary to prevent foreclosure or eviction and, pursuant to a relatively recent IRS proposal, expenses and losses incurred due to a federally incurred disaster area where the participant's residence or principal place of business

is located. Employers should review their plans and work with their record keepers to make sure that employees will have access to their accounts. The downside to these distributions is that they are not only subject to immediate taxation, but they may be subject to an additional 10% tax on premature distributions.

5. Plan In-Service Distributions. Because a 401(k) plan is supposed to provide for retirement savings, the IRS restricts in-service distributions of employee salary deferrals from 401(k) plans (except plan loans and hardships as discussed above). However, the plan can permit in-service distributions to participants who have attained age 59-1/2 and older. In addition, that same restriction does not apply to employer contributions (such as matching contributions and profit sharing contributions). The employer generally can permit in-service distribution of these amounts (but only if the contributions were made more than 2 years ago).

Payments to Employees Using Existing Employer-Sponsored Charitable Vehicle

Some employers will already have a charitable vehicle in place that can be used to make non-taxable payments to employees, such as through an existing employee assistance fund. It is important to understand what type of charitable vehicle is in place, since the types of payments that may be made to employees on a tax-free basis vary depending on the type of vehicle.

Note that if an employer is only providing QDRPs to employees, making this same assistance available through a charitable vehicle offers no additional tax benefit for the employee, but it does provide the option for others (including the employer, employees, and sponsors) to make tax-deductible contributions to the employee relief effort.

Private Foundation

It is common for employer-sponsored charities to be structured as private foundations, because generally such charities have a limited number of funding sources and therefore cannot qualify for “public charity” status. If an employer already has a company foundation structured as a private foundation, IRS guidance permits the foundation to provide financial assistance to employees and their family members on a tax-free basis, but only with respect to qualified disasters (such as the COVID-19 pandemic). Recipients of financial assistance must be selected based on a determination of need, and the selection of recipients needs to be made in a manner that ensures any benefit to the employer is incidental and tenuous. IRS guidance indicates this requirement may be met if a majority of the selection committee consists of individuals who are not in a position to exercise substantial influence over the employer’s affairs. Note that “disqualified persons” of the foundation, such as directors, trustees, and officers of the foundation, or members of the foundation’s selection committee, cannot receive financial assistance from the foundation.

An employer-sponsored private foundation may accept charitable contributions from the employer, employees, and others (such as sponsors) to fund its operations, including costs associated with an employee assistance fund.[2]

[2] The deductibility rules that apply to contributions by individuals to private foundations are different than the rules that apply to contributions to public charities, including DAFs. Cash contributions to private foundations are generally deductible on a less

Donor-Advised Fund

Some employers may have established a donor-advised fund (DAF) at a community foundation or other sponsoring charity for the purpose of providing assistance to employees in times of need. A DAF is an account set up at a charity that receives contributions from donors (providing an immediate charitable deduction) and takes recommendations from donors as to how the funds are ultimately distributed. While DAFs are generally prohibited from making distributions to individuals, an exception exists for employer-sponsored DAFs that make payments to employees and their family members as a result of a qualified disaster (such as the COVID-19 pandemic). In order for a DAF to qualify to make such payments (which are tax-free to the recipients), it must serve the single identified purpose of providing relief from qualified disasters. In addition, recipients of financial assistance must be selected based on a determination of need, and the selection of recipients needs to be made in a manner that ensures any benefit to the employer is incidental and tenuous. IRS guidance indicates this requirement may be met if a majority of the selection committee consists of individuals who are not in a position to exercise substantial influence over the employer's affairs. Note that "disqualified persons" of the DAF, such as directors, trustees, and officers of the community foundation or other sponsoring charity where the DAF is maintained, or members of the DAF's selection committee, cannot receive financial assistance from the DAF. Note that the donor-advisor to the DAF (generally the employer) has the right to make recommendations as to how assistance will be distributed to affected employees, and the ultimate decision is made by the community foundation or other sponsoring charity.

An employer-sponsored DAF may accept charitable contributions from the employer, employees, and others (such as sponsors).

Public Charity

Because most employer-sponsored charities are not funded by donations from a broad group of donors, it is somewhat unusual for such a charity to qualify for "public charity" status. However, if an existing employer-sponsored charity is a public charity, IRS guidance permits the charity to provide financial assistance to employees and their family members on a tax-free basis when they have been affected by disasters or other emergency hardship situations. Note this is broader than the type of assistance that may be provided through private foundations and DAFs, where support is limited to those affected by qualified disasters. As with the requirements for providing financial assistance to employees through private foundations and DAFs, assistance may only be provided after a determination of need and the selection of recipients needs to be made in a manner that ensures any benefit to the employer is incidental and tenuous.

An employer-sponsored public charity may accept charitable contributions from the employer, employees, and others (such as sponsors) to fund its operations, including costs associated with an employee assistance fund.

Payments to Employees Using Newly-Created Charitable Vehicle

If an employer does not have an existing charitable vehicle, it could establish a new vehicle to provide employee assistance (therefore affording donors charitable deductions). Given the immediate needs associated with the COVID-19 pandemic, it would likely be impractical to establish a new private foundation or public charity, given that the entity

favorable basis than cash contributions to public charities, and a fair market value deduction for a gift of non-publicly traded stock is generally available only for a contribution to a public charity, not for a contribution to a private foundation.

would need to apply for tax-exempt status from the IRS (while tax-exempt status is generally retroactive to date of formation, some donors are uncomfortable making contributions to charities before they have obtained an IRS determination letter). However, there are other options for employers:

- A DAF can be established quickly with an existing community foundation or other sponsoring charity. The rules described above would apply to employee assistance provided through the DAF.

- An employee assistance fund could be created at an existing public charity and "private labeled" for the employer. Typically, the employer would set eligibility requirements and other parameters for employees to receive assistance from the fund, and the public charity would handle administration. The rules described above would apply to employee assistance provided through the public charity.

Under either of these options, the employer has the right to make recommendations as to how assistance will be distributed to affected employees, and the ultimate decision is made by the sponsoring charity.

Provided agreed to by the charity sponsoring the employee assistance fund, these charitable vehicles could accept charitable contributions from the employer, employees, and others (such as sponsors).