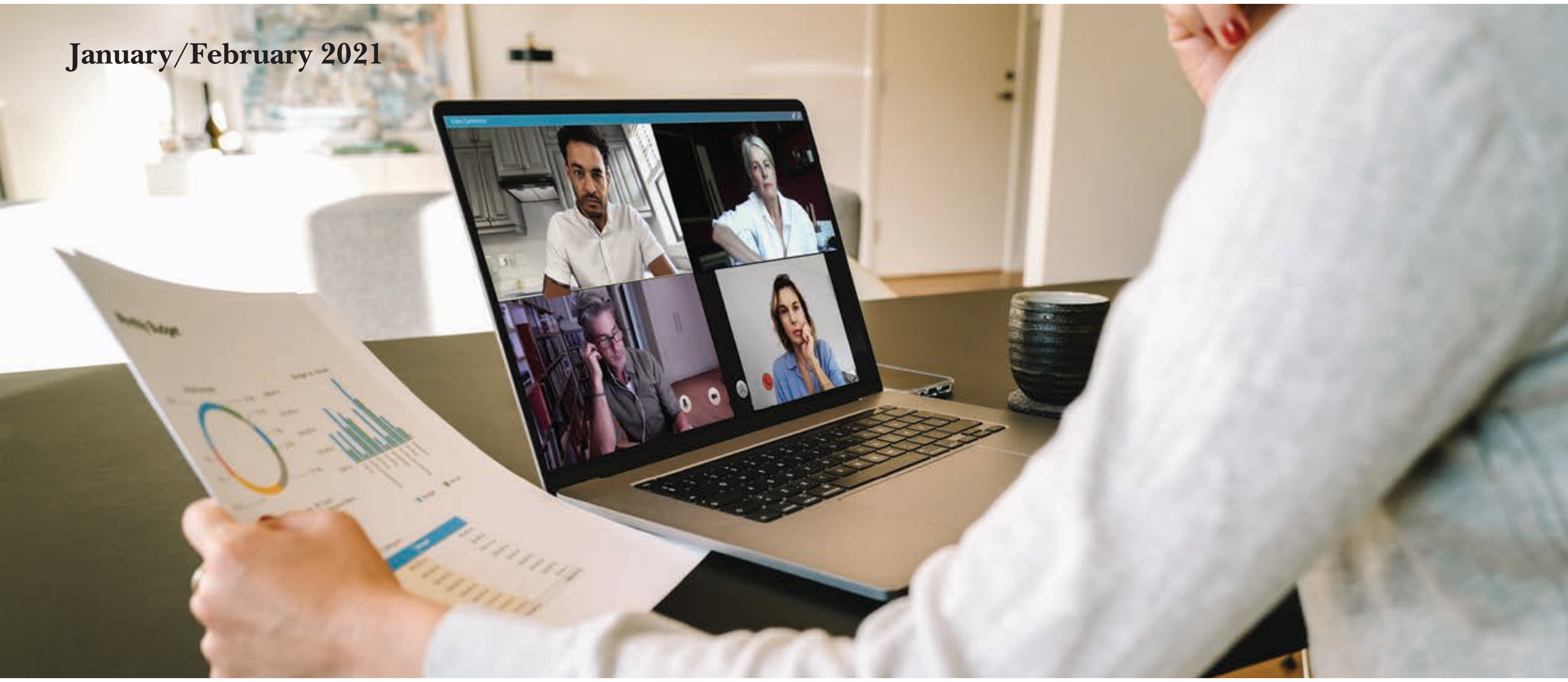
Tax Impact

January/February 2021



Section 139
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Tax Tips

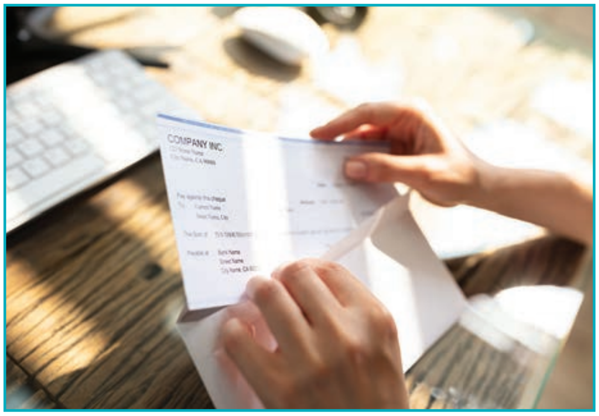
Section 139

How to provide your employees with tax-free COVID-19 relief

The COVID-19 pandemic has led to a surge in unemployment. And while people who have been furloughed or lost their jobs are among the hardest hit by the pandemic, those who remain employed have also experienced financial hardships. Fortunately, the tax code provides some incentives for employers who wish to provide their employees with assistance.

Internal Revenue Code Section 139 provides tax breaks for "qualified disaster relief payments," including payments on account of COVID-19, which was declared a federal disaster last spring. (See "What's a qualified disaster?" on page 3.) Payments may qualify whether they're made by an employer, a government agency, a charity or some other organization.

To streamline the distribution of relief, Sec. 139 dispenses with some of the formalities required for other types of benefits, such as having a written plan and requiring recipients to substantiate their need. Nevertheless, it's recommended that employers put their plans in writing and ask employees to document their expenses.



Assistance that qualifies for Sec. 139

Under Sec. 139, qualified disaster relief payments include amounts paid to or for the benefit of an individual to 1) reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster, or 2) reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster. (Certain payments by government agencies or common carriers also qualify.)

These payments qualify only to the extent that the recipient's expenses aren't otherwise reimbursed or paid by insurance.

The IRS hasn't provided COVID-19–specific guidance on qualified disaster relief, but presumably tax-advantaged treatment would be available for:

- Unreimbursed medical expenses, such as co-pays, nonprescription drugs or critical care, for COVID-19 treatment,
- Other expenses incurred as a result of COVID-19, such as masks, hand sanitizer, disinfectant cleaning products and grocery delivery services,
- Funeral expenses for an employee or family member who dies of COVID-19,
- Equipment or services needed to work remotely, such as computers, printers and Internet service, and
- New or increased expenses for children as a result of virtual learning requirements or school closings.

Qualified disaster relief *doesn't* include payments that constitute compensation (for example, lost wages or sick pay) or payments for nonessential or luxury items.

Tax benefits for employers and employees

Qualified disaster relief payments are income-tax-free to employees. From the employer's perspective, qualified disaster relief payments are generally deductible as ordinary and necessary business expenses. However, because they're not considered compensation, neither the employer nor the employee is subject to payroll taxes (such as Social Security, Medicare or unemployment) on these payments.

Advantages of having a formal plan

As noted above, Sec. 139 doesn't require you to prepare a written disaster relief plan. But there are definite advantages to doing so. A written plan is a great way to communicate your COVID-19 relief policy to employees and to outline the types of expenses you'll pay or reimburse, employee eligibility requirements (if any), the procedures for requesting relief, methods of payment or reimbursement, and the program's start and end dates.

Unlike other expense reimbursement arrangements — such as for travel or meals — Sec. 139 doesn't require you to obtain receipts, canceled checks or other substantiation from employees. According to a 2003 IRS ruling, payments meet Sec. 139 requirements so long as you reasonably expect them to be "commensurate with" employees' actual expenses. Nevertheless, it's advisable to require employees to document their expenses to ensure that they meet the "commensurate with" standard and to avoid excessive — or even fraudulent — claims.

What's a qualified disaster?

Under Section 139, "qualified disasters" include:

- Disasters that result from terroristic or military actions,
- Federally declared disasters,
- Disasters that result from an accident involving a common carrier, or from other "catastrophic" events, and
- For certain government relief payments, disasters determined by applicable federal, state or local authorities to warrant government assistance.

COVID-19 qualifies as a federally declared disaster — that is, one that was determined by the President to warrant federal government assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. Although the disaster declaration didn't specify an end date, the President has the power to lift the disaster designation.

Your payroll or benefits vendors can help

If you're considering disaster relief, but you're concerned about your staff's ability to handle the extra workload, find out if your payroll or benefits vendors can help. Many of these providers are now equipped to administer Sec. 139 programs. They're able to facilitate disaster relief payments and ensure that the related tax benefits are properly structured and tracked.

Avoid tax surprises

If you'd like to provide your employees with tax-free COVID-19 assistance, plan carefully to avoid unexpected tax consequences. Your tax advisor can help you ensure that relief payments meet the requirements of Sec. 139 and won't expose your employees to additional tax liabilities down the road. ■

Are you liable for “nanny taxes”?

During the COVID-19 pandemic, day care centers have closed, summer camps have been canceled and many schools have switched to a remote learning model. As a result, working parents have had to scramble to make alternative child care arrangements, which may include hiring nannies or babysitters. If you employ household workers — which may also include housekeepers, cooks, gardeners, health care workers and other employees — it’s important to understand your tax obligations. Here’s a quick review.

Which workers are covered?

Someone working in your home doesn’t necessarily make him or her a household employee. You’re not required to withhold or pay taxes for independent contractors — such as occasional babysitters who work for many different families. The rules for distinguishing between employees and independent contractors are complicated, however, so be sure to consult your tax advisor if you’re uncertain.

Which taxes must you pay?

Your tax obligations vary depending on the type of tax:

Income tax. You’re not required to withhold federal income taxes (or, usually, state income taxes) from a household employee’s pay, unless the employee asks you to and you agree. In that case, you’ll need to have the employee complete Form W-4 and you’ll need to withhold income taxes on both cash and noncash wages (other than certain meals and lodging).

FICA taxes. You must withhold and pay FICA taxes (Social Security and Medicare) if your household employee’s cash wages reach a specified threshold ($2,200 for 2020). If you meet the threshold, you must pay the employer’s share of Social Security taxes (6.2%) and Medicare taxes (1.45%) on the employee’s cash wages (but not on meals, lodging or other noncash wages). In addition, you’re responsible for withholding the employee’s share of these taxes (also 6.2% and 1.45%, respectively), although you may opt to pay the employee’s share rather than withholding it from his or her pay.

Note: There’s no FICA tax liability for wages you pay to certain family members or to household employees under the age of 18 if working for you isn’t their principal occupation. A student who babysits on the side would be one example.

Unemployment taxes. You must pay federal unemployment tax (FUTA) if you pay total cash wages to household employees (other than certain family members) of $1,000 or more in any quarter in the current or preceding calendar year. The tax applies to the first $7,000 of an employee's cash wages at a 6% rate, although credits reduce that rate to 0.6% in most cases.

How are taxes reported and paid?

Unlike businesses, you generally don't need to file quarterly employment tax returns for household employees. Rather, you report household employment taxes on Schedule H of your personal income tax return. However, if you own a business as a sole proprietor, you may add the taxes for household employees to the deposits or payments you make for your business employees and include household employees on Forms 940 and 941.

Even if you report household employment taxes on Schedule H, you're still responsible for paying the tax throughout the year, either through quarterly estimated tax payments or by increasing withholdings from your wages. Otherwise, you'll have to pay the tax when you file your return and be subjected to penalties for underpayment of estimated tax.

You'll also need to file Form W-2 if you're required to withhold FICA taxes or agree to withhold income taxes for a household employee.

Know your obligations as an employer

In addition to the tax requirements discussed above, there may be other obligations that come with being an employer. These may include complying with minimum wage and overtime requirements, and documenting immigration status. Turn to your tax advisor for more information. ■

Easing the pain of the NIIT on your estate plan

The 3.8% net investment income tax (NIIT) can negatively affect your estate plan. This is especially true if your assets include an investment portfolio, because the NIIT can increase the tax on your capital gains, taxable interest and other investment income, thus reducing the amount of wealth available to your family. In addition, the NIIT can be detrimental on certain trusts.

The NIIT in action

The NIIT applies to individuals with modified adjusted gross income (MAGI) over $200,000. The threshold is $250,000 for joint filers and qualifying widows or widowers and $125,000 for married taxpayers filing separately. The tax is equal to 3.8% of 1) your net investment income, or 2) the amount by which your MAGI exceeds the threshold, whichever is less.

> ***If you own an interest in a business, you may be able to reduce NIIT by increasing your level of participation.***

Suppose, for example, that you're married filing jointly and you have $350,000 in MAGI. Presuming $125,000 in net investment income, your NIIT is

3.8% of $100,000 (the excess of your MAGI over the threshold, which is less than your net investment income), or $3,800.

Nongrantor trusts — with limited exceptions — are also subject to the NIIT, and at a much lower threshold: For 2020, the tax applies to the lesser of 1) the trust's undistributed net investment income, or 2) the amount by which the trust's AGI exceeds $12,950.

Reducing the tax

You can reduce or eliminate the NIIT by lowering your MAGI, lowering your net investment income, or both. Techniques for doing so include:

- Reducing this year's MAGI by deferring income, accelerating expenses or maxing out contributions to retirement accounts,
- Selling poor-performing investments to offset the losses against investment gains you've realized during the year, or
- Reducing net investment income by investing in tax-exempt municipal bonds or in growth stocks that generate little or no current income.

If you own an interest in a business, you may be able to reduce NIIT by increasing your level of participation. Income from a business in which you "materially participate" isn't considered net investment income. (But keep in mind that increasing your participation may, in certain cases, trigger self-employment tax liability.)

Planning strategies for trusts

Given the low AGI threshold for trusts, income reduction strategies are of little value. But it's important to understand that the NIIT applies only to a trust's *undistributed* NII. One way to avoid the NIIT is to distribute all of its income to lower-income beneficiaries.

Understand that capital gains ordinarily aren't included in a trust's distributable net income (DNI), so they're taxed at the trust level. Depending on state law and the trust's language, however, it may be possible to include capital gains in DNI and, at least at the trust level, avoid NIIT on them. Of course, the beneficiary or beneficiaries of the trust may be subject to NIIT, so it's important to plan accordingly.

You can also avoid NIIT by designing a trust as a grantor trust. Grantor trusts aren't taxed at the trust level; rather, their income is passed through to you, as grantor, and taxed at your individual income tax rate. This strategy avoids NIIT on the trust's investment income, but it may increase NIIT on your individual return, so be sure to evaluate its overall tax impact.

Turn to your advisor

As you review your estate plan, talk to your advisor about opportunities to reduce or eliminate NIIT. As always, tax planning is important, but it shouldn't override other estate and financial planning considerations. Distributing a trust's income to its beneficiaries, for example, may reduce its tax bill, but it may also defeat the trust's estate planning purposes. ■

What if you can't pay your taxes on time?

If you're unable to pay your tax bill by April 15, you have several options, but doing nothing isn't one of them. At the very least, you should file your return to avoid failure to file penalties of 5% of your tax liability per month, up to a maximum of 25%. You'll still owe failure to pay penalties, which accrue at 0.5% per month, up to a maximum of 25%, but you may be able to get an "undue hardship" extension of 18 months (or possibly longer). In that case, you'll avoid penalties, though you'll have to pay interest.

Another option is to request an installment payment agreement, which includes interest and reduced penalties. Or you could borrow money from a relative or friend. Bank loans may also be a possibility, but often the interest and fees exceed what you'd pay under an installment agreement. ■

Annual exclusion gifts: Don't underestimate their power

The federal gift and estate tax exemption is a whopping $11.7 million for 2021, so for many people estate planning may not seem all that important. But consider this: The exemption is scheduled to be cut in half at the end of 2025, and there's talk in Congress about reducing it even earlier, to as little as $3.5 million. Even if you're not ready for complex estate planning strategies, annual exclusion gifts can be a simple yet powerful tool for reducing your potential transfer tax liability.

You're permitted to give up to $15,000 to any number of recipients each year, without using any of your exemption amount. If you split gifts with your spouse, that amount doubles to $30,000 per recipient. Say you and your spouse have three children, all of whom are married. You can make annual exclusion gifts of $30,000 per year to each child and each spouse, for a total of $180,000. In five years, you'll have transferred $900,000 out of your estate tax-free, while preserving your lifetime exemption. ■

New guidance on business meals and entertainment

In 2017, the Tax Cuts and Jobs Act eliminated the deduction for business expenses related to entertainment, amusement or recreation (with a few exceptions). Business expenses for food and beverages remain deductible (generally up to 50% of qualifying expenditures). Recently, the IRS finalized regulations that explain the disallowance of entertainment expenses and provide guidance on determining whether an activity is considered entertainment and, if so, whether it falls under one of the exceptions. The regulations also provide guidance on the deduction of expenses for food and beverages, the application of the 50% limit, and the exceptions to that limit. ■

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