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Direct Employer Assistance and 401(k) Plan Relief Options for Employees Affected by California Wildfires

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In the past week, devastating wildfires in Los Angeles, California, have caused unprecedented destruction across the region, leading to loss of life and displacing tens of thousands. While still ongoing, the fires already have the potential to be the worst natural disaster in United States history.

Quick Hits

- Employers can assist employees affected by the Los Angeles wildfires through qualified disaster relief payments under Section 139 of the Internal Revenue Code, which are tax-exempt for employees and deductible for employers.
- The SECURE Act 2.0 allows employees impacted by federally declared disasters to take immediate distributions from their 401(k) plans without the usual penalties, provided their plan includes such provisions.

As impacted communities band together and donations begin to flow to families in need, many employers are eager to take steps to assist employees affected by the disaster.

As discussed below, the Internal Revenue Code provides employers with the ability to make qualified disaster relief payments to employees in need. In addition, for employers maintaining a 401(k) plan, optional 401(k) plan provisions can enable employees to obtain in-service distributions based on hardship or federally declared disaster.

Internal Revenue Code Section 139 Disaster Relief

Section 139 of the Internal Revenue Code provides for a federal income exclusion for payments received due to a “qualified disaster.” Under Section 139, an employer can provide employees with direct cash assistance to help them with costs incurred in connection with the disaster. Employees are not responsible for income tax, and payments are generally characterized as deductible business expenses for employers. Neither the employees nor the employer are responsible for federal payroll taxes associated with such payments.

“Qualified disasters” include presidentially declared disasters, including natural disasters and the coronavirus pandemic, terrorist or military events, common carrier accidents (e.g., passenger train collisions), and other events that the U.S. Secretary of the Treasury concludes are catastrophic. On January 8, 2025, President Biden approved a Major Disaster Declaration for California based on the Los Angeles wildfires.

In addition to the requirement that payments be made pursuant to a qualified disaster, payments must be for the purpose of reimbursing reasonable and necessary “personal, family, living, or funeral expenses,” costs of home repair, and to reimburse the replacement of personal items due to the disaster. Payment cannot be made to compensate employees for expenses already compensated by insurance.

Employers implementing qualified disaster relief plans should maintain a written policy explaining that payments are intended to approximate the losses actually incurred by employees. In the event of an audit, the employer should also be prepared to substantiate payments by retaining communications with employees and any expense documentation. Employers should also review their 401(k) plan documents to determine that payments are not characterized as deferral-eligible compensation and consider any state law implications surrounding cash payments to employees.

401(k) Hardship and Disaster Distributions

In addition to the Section 139 disaster relief described above, employees may be able to take an immediate distribution from their 401(k) plan under the hardship withdrawal rules and disaster relief under the SECURE 2.0 Act of 2022 (SECURE 2.0).

Hardship Distributions

If permitted under the plan, a participant may apply for and receive an in-service distribution based on an unforeseen hardship that presents an “immediate and heavy” financial need. Whether a need is immediate and heavy depends on the participant’s unique facts and circumstances. Under the hardship distribution rules, expenses and losses (including loss of income) incurred by an employee on account of a federally declared disaster declaration are considered immediate and heavy provided that the employee’s principal residence or principal place of employment was in the disaster zone.

The amount of a hardship distribution must be limited to the amount necessary to satisfy the need. If the employee has other resources available to meet the need, then there is no basis for a hardship distribution. In addition, hardship distributions are generally subject to income tax in the year of distribution and an additional 10 percent early withdrawal penalty if the participant is below age 59 and a half. The participant must submit certification regarding the hardship to the plan sponsor, which the plan sponsor is then entitled to rely upon.

Qualified Disaster Recovery Distributions

Separate from the hardship distribution rules described above, SECURE 2.0 provides special rules for in-service distributions from retirement plans and for plan loans to certain “qualified individuals” impacted by federally declared major disasters. These special in-service distributions are not subject to the same immediate and heavy need requirements and tax rules as hardship distributions and are eligible for repayment.

SECURE 2.0 allows for the following disaster relief:

- *Qualified Disaster Recovery Distributions*. Qualified individuals may receive up to $22,000 of Disaster Recovery Distributions (QDRD) from eligible retirement plans (certain employer-sponsored retirement plans, such as section 401(k) and 403(b) plans, and IRAs). There are also special rollover and repayment rules available with respect to these distributions.
- *Increased Plan Loans*. SECURE 2.0 provides for an increased limit on the amount a qualified individual may borrow from an eligible retirement plan. Specifically, an employer may increase the dollar limit under the plan for plan loans up to the full amount of the participant's vested balance in their plan account, but not more than $100,000 (reduced by the amount of any outstanding plan loans). An employer can also allow up to an additional year for qualified individuals to repay their plan loans.

Under SECURE 2.0, an individual is considered a qualified individual if:

- the individual's principal residence at any time during the incident period of any qualified disaster is in the qualified disaster area with respect to that disaster; and
- the individual has sustained an economic loss by reason of that qualified disaster.

A QDRD must be requested within 180 days after the date of the qualified disaster declaration (i.e., January 8, 2025, for the 2025 Los Angeles wildfires). Unlike hardship distributions, a QDRD is not subject to the 10 percent early withdrawal penalty for participants under age 59 and a half. Further, unlike hardship distributions, taxation of the QDRD can be spread over three tax years and a qualified individual may repay all or part of the amount of a QDRD within a three-year period beginning on the day after the date of the distribution.

As indicated above, like hardship distributions, QDRDs are an optional plan feature. Accordingly, in order for QDRDs to be available, the plan's written terms must provide for them.

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