Employee Benefits & Executive Compensation Bulletin

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HEART Act Provides Benefits for Employees on Military Leave

The Heroes Earnings Assistance and Relief Tax Act of 2008 ("HEART Act") was signed into law on June 17th of this year. For the most part, the HEART Act amends the Internal Revenue Code of 1986 ("Code") to provide enhanced employee benefits to military personnel and their beneficiaries while such individuals are serving in the military. It also it addresses the treatment of certain wages paid to individuals while on active duty. This Bulletin describes the affect the HEART Act will have on qualified plans, 403(b) plans, 457(b) plans, and health flexible spending arrangements ("health FSAs"), and includes a discussion of action steps that employers will want to consider as a result of the legislation.

Qualified Plans, 403(b) Plans and 457(b) Plans

Set forth below are both required and optional provisions of the HEART Act that apply to qualified retirement plans, 403(b) annuity plans, and 457(b) governmental deferred compensation plans.

- Death Benefit. Effective retroactive to January 1, 2007, beneficiaries of an individual who dies while performing qualified military service must be entitled to the same death benefits that would have been available to the beneficiaries had the individual been employed by the employer on his or her date of death.

- Service. An employer may include an individual's qualified military service for benefit accrual purposes if he or she dies or becomes disabled during qualified military service.

- Early Distribution Penalty. The exemption of the 10% early distribution penalty tax for qualified reservist distributions, which are distributions of pre-tax contributions to a plan by a participant called to active duty for an extended period, is made permanent. This exemption had an original expiration date of December 31, 2007.

- Distribution. Effective January 1, 2009, if an individual takes a distribution due to "severance from employment" while on qualified military service which exceeds 30 days, the plan must provide that the individual may not make elective deferrals or employee contributions during the 6-month period beginning on the date of the distribution.

- Differential Pay. If an employer chooses to make payments to an individual on military leave for a period that exceeds 30 days, and represents the difference between the individual's

income as an employee and the income, if less, that is provided by the military, this "differential pay" will be considered compensation for purposes of determining contributions or benefits under the applicable plan. Beginning next year, military differential pay will also be considered wages for purposes of income tax withholding (currently differential wage payments are treated as benefits reportable on IRS Form 1099).

Health Flexible Spending Arrangements

Health FSAs are health plans designed to allow employees to pay for certain out-of-pocket medical expenses on a pre-tax basis. These plans are funded through employee, and sometimes, employer contributions. One disadvantage associated with contributing to a health FSAs has historically been the "use-it-or-lose-it" rule. This rule requires the forfeiture of any unused amounts in a participant's account at the end of the plan year. Because of this strict rule, it is possible that an individual can be called to active duty through the end of the plan year, and be forced to forfeit any balance remaining in his or her health FSA.

The HEART Act permits plans to allow "qualified reservist distributions." A qualified reservist distribution is a distribution of all or a portion of the balance in an employee's health FSA if the employee is a member of a reserve component and is called to active duty for 180 days or more and the distribution is made between the period beginning on the date of the call and ending on the last day of the plan year.

HEART Act Action Steps

The following summarizes that mandatory and optional action steps that employers may need to take in light of the HEART Act.

- ✓ Plan sponsors must determine if their qualified plans, 403(b) plans, and/or 457(b) plans provide any enhanced benefits to beneficiaries of participants who die during active employment as opposed to those who die while not employed due to qualified military service. For example, a plan may provide for full vesting upon death during active employment or a subsidized survivor benefit. If a plan provides an enhanced or better benefit to a participant who dies during active employment, the plan sponsor must determine whether any former employees died during military service on or after January 1, 2007. An additional benefit may be required to be paid to the beneficiaries of these individuals. Going forward, sponsors must ensure that these beneficiaries are entitled to the same benefits as those beneficiaries of actively employed participants. Amendments must be made by the end of the plan year beginning on or after January 1, 2010.

- ✓ Plan sponsors must determine if the plan will provide benefit accruals for the period of military service of an individual who dies or becomes disabled during a period of military service. If so, the plan must be amended no later than the last day of the plan year beginning on or after January 1, 2010.

- ✓ Any employer that provides differential military pay, must modify its payroll practices to treat such payments as wages for purposes of income tax withholding with respect to amounts paid after January 1, 2009.

- ✓ Plan sponsors must allow contributions to a qualified plan, 403(b) plan or 457(b) plan to be made from differential military pay beginning after January 1, 2009. To comply with this

provision, plans must be amended by no later than the last day of the plan year beginning on or after January 1, 2010 to implement the contributions and impose the required 6-month suspension if the individual takes a distribution from the plan during military service.

- ✓ Plan sponsors must determine whether a health FSA will permit qualified reservist distributions, and, if so, amend the plan to allow for the distributions. It is not clear when the IRS will require the amendment be in place. Therefore, amending the plan to permit the distribution prior to making the first distribution is recommended.

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