

in this issue:

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The newly enacted Heroes Earnings Assistance and Relief Tax Act (HEART Act) of 2008 protects death benefits and provides tax relief to those serving in active military duty.

Employee Benefits

A Littler Mendelson Newsletter

HEART Act Affords Greater Protections to Those Serving in Active Military Duty

By Lisa A. Taggart

On June 17, 2008, President Bush signed into law the Heroes Earnings Assistance and Relief Tax Act of 2008 (the "HEART Act"). The HEART Act provides tax relief and other benefits to members of the armed forces who are called to active military duty. Under the Act, retirement plans must provide certain survivor benefits to participants who die while serving in active military duty and make plan contributions for "differential pay." The Act also modifies the tax treatment of certain deferred compensation items.

Survivor Payments

In general, the job and benefit protections provided to veterans prior to the HEART Act did not apply if the veteran was not reemployed within certain time frames by his or her employer after serving in active military duty. As a result, those who failed to return to employment due to death or disability were largely unprotected.

The HEART Act requires that benefits otherwise payable on the death of an active employee under a qualified plan or a plan established under Sections 403(b) or 457(b) of the Internal Revenue Code ("Code"), must also be payable upon the death of such employee if he or she dies while performing "qualified military service" (as defined under the Uniform Services Employment and Reemployment Rights Act of 1994 (USERRA)). If a retirement plan provides accelerated vesting, ancillary life insurance benefits, or other survivor benefits that are contingent upon a participant's termination of employment due to death, the plan must now provide such benefits to the beneficiary

of a participant who dies while serving in qualified military service.

A retirement plan is *permitted* under the HEART Act to treat an individual who leaves employment for qualified military service and who cannot be reemployed due to death or disability as if he or she had been rehired on the day before death or disability. This has the effect of restoring benefits in the manner set forth under USERRA as though a former employee was in fact rehired. If a plan credits certain benefits to former employees who are deemed to be rehired employees that are contingent on employee contributions or elective contributions, the rate of employee contributions is determined by the rate of actual average contributions or deferrals made by the employee during the 12-month period prior to military service. Any employer choosing to provide this benefit must do so on a reasonably equivalent basis to similarly situated employees.

The death benefit provisions of the HEART Act apply to deaths occurring on or after January 1, 2007. Plan documents must be amended to reflect these requirements before the last day of the first plan year beginning on or after January 1, 2010.

Differential Military Pay

Differential military pay is defined generally as compensation that is voluntarily paid by an employer to an employee who is called to active military duty, at the same level of compensation that the employee would have received had the employee remained actively employed.

Under prior law, differential pay was not subject to income tax withholding because an employee called to active duty was treated as having terminated employment. It was also not required to be treated as compensation for retirement plan purposes. Final regulations in 2007 *permitted* plans to treat differential pay as compensation for benefit plan limits under Section 415 of the Code.

The HEART Act now requires that an individual receiving a differential wage payment be treated as an employee of the employer making the payment. Correspondingly, the differential payment must be treated as compensation under any retirement plan subject to USERRA. Differential pay is specifically defined under the HEART Act as any payment that: (1) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services while on active duty for a period of more than 30 days; and (2) represents all or a portion of the wages that the individual would have received from the employer if the individual had remained actively employed.

Contributions based on differential pay will not cause a retirement plan to fail the minimum participation and nondiscrimination requirements, provided: (1) all employees are entitled to differential wage payments on a reasonably equivalent basis; and (2) all employees eligible to make contributions based on a differential wage payment are entitled to contribute on reasonably equivalent terms.

The differential pay provisions of the HEART Act are effective for plan years beginning on or after January 1, 2009. As with other HEART Act provisions, plan documents must be amended to reflect these provisions no later than the last day of the first plan year beginning on or after January 1, 2010.

Permanent Reservist Exception

Under current law, a distribution under a qualified plan prior to age 59 1/2, death, or disability is subject to a 10% early withdrawal penalty. Certain exceptions to this rule apply for: (1) distributions to an employee who separates from service after age 55; and (2) distributions that are part of a series of substantial equal periodic payments made for the

life or life expectancy of the participant or joint life expectancies of a participant and his or her beneficiary.

The Pension Protection Act (PPA) of 2006 established another exception to the 10% penalty for “qualified reservist distributions.” A qualified reservist distribution is a distribution that is made: (1) from an individual retirement account (IRA) or from a participant’s elective deferrals under a 401(k) plan, 403(b) annuity, or similar arrangement; (2) to certain individuals called to active duty for a period of at least 180 days or an indefinite period; and (3) during the period beginning on the date of such call to duty and ending at the close of the active duty period. A section 401(k) plan or 403(b) annuity making such a distribution does not violate any restrictions prohibiting payment before age 59 1/2, death, disability, or financial hardship.

Those receiving qualified reservist distributions may contribute the amount of the distribution to an IRA within two years of the end of their active military duty. Dollar limits otherwise applicable to IRAs do not apply to distributions made under this rule.

The qualified reservist distribution exception in the PPA applies to individuals called to duty after September 11, 2001 and before December 31, 2007. Under the HEART Act, the qualified reservist distribution has been made permanent for distributions on or after December 31, 2007.

Unused Benefits in Flexible Spending Accounts

A cafeteria plan or health flexible spending account (FSA) is subject to the “use it or lose it” rule, which requires that amounts in an employee’s FSA that are not used for medical expenses incurred by the end of a plan year (or plan year plus grace period) must be forfeited. An FSA arrangement that does not follow the “use it or lose it” rule for any participant is no longer a cafeteria plan. As a result, *all* benefits under the arrangement become taxable income to participants.

Under the HEART Act, however, a health FSA may permit unused FSA contributions for reservist distributions. A qualified reservist distribution in the FSA context is one that is made: (1) to a participant/reservist called to active duty for a period of at least 180 days (or

for an indefinite period); and (2) during the period beginning with the call to active duty and ending on the last day of the coverage period for the FSA that includes the date of the call to active duty.

The allowance of qualified reservist distributions for unused FSA accounts is effective for distributions on or after the date of enactment of the HEART Act, or June 17, 2008.

Military Death Benefit Eligible for Rollover into Roth IRAs and Coverdell Savings Accounts

A military death benefit is payable to an eligible survivor of a servicemember under Section 1477 of Title 10 of the United States Code. In addition, Section 1967 of the United States Code provides certain servicemembers with life insurance under the Servicemembers’ Group Life Insurance (SGLI) program.

The HEART Act allows individuals receiving a military death benefit or SGLI payment to contribute the benefit to a Roth IRA or Coverdell education savings account, notwithstanding the contribution limits applicable to these accounts. The maximum amount that may be contributed to a Roth IRA or one or more Coverdell education savings accounts is the sum of the death benefit and any SGLI payments. The contribution must be made no later than one year after the death benefit or SGLI payment is received.

In general, these rollover provisions of the HEART Act apply to deaths from injuries occurring on or after June 17, 2008. However, such rollovers may be made with respect to payments received due to death from injuries occurring on or after October 7, 2001, and before June 17, 2008, if they are made no later than 1 year from the enactment of the HEART Act, or by June 17, 2009.

Special Rules for Deferred Compensation and Tax-Deferred Accounts of Expatriates

The HEART Act contains provisions that apply to “eligible deferred compensation items” of certain U.S. citizens who give up their U.S. citizenship and long-term residents who give up their U.S. residence. The plans and arrangements affected by these provisions are: (1)

qualified plans under Section 401(a) of the Code; (2) annuity plans established under Section 403(a) of the Code; (3) annuity contracts established under Section 403(b) of the Code; (4) simplified employee pension plans (SEPs); (5) simple IRAs; and (6) plans established under Section 457(b) of the Code.

An eligible deferred compensation item is a deferred compensation item with respect to which: (1) the payor/employer is either a U.S. person or a non-U.S. person who elects to be treated as a U.S. person for purposes of income tax withholding requirements; and (2) the covered expatriate notifies the payor of his status as a covered expatriate and irrevocably waives any claims of withholding reduction in an amount prescribed under any treaty with the U.S.

Under the HEART Act, the payor/employer must deduct and withhold for taxes 30% of the amount of any eligible deferred compensation item. This withholding is in place of any other withholding required under present law. If a deferred compensation item is *not* an “eligible deferred compensation item,” an amount equal to the value of the expatriate’s deferred compensation item is treated as having been received on the day before the expatriation date. The new rules do not apply to items attributable to services performed outside the U.S. while the covered expatriate was not a citizen or resident of the U.S.

The HEART Act also addresses the interests of covered expatriates in “specified tax deferred accounts.” A specified tax deferred account is an IRA, a qualified tuition plan, a Coverdell education savings account, a health savings account, or an Archer MSA. If a covered expatriate holds an interest in a specified tax deferred account on the day before his or her expatriation date, the HEART Act requires that such covered expatriate be treated as having received a distribution of his or her entire interest in the account on the date before the expatriation date. Appropriate adjustments are made for subsequent distributions to take into account this treatment.

The expatriate taxation rules under the HEART Act are effective for U.S. citizens relinquishing citizenship or terminating residency on or after June 17, 2008.

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