

Management Alert

Heroes Earnings Assistance and Relief Tax Act of 2008: Impact on Employee Benefit Plans

On June 17, 2008, President Bush signed into law the Heroes Earnings Assistance and Relief Tax Act of 2008 (the "HEART Act"), which contains mandatory and optional provisions that impact retirement plan benefits and Health FSAs provided to employees performing "qualified military service" (generally, military service that is covered by USERRA). These provisions are summarized below.

Mandatory retirement plan changes required by the HEART Act:

- *New "Survivor Benefit" Requirement.* The HEART Act adds a new requirement for qualified retirement plans (including 403(b) and 457(b) plans) to treat employees who die while performing qualified military service as if they had resumed employment on the day before death for purposes of determining the employees' survivors' entitlement to benefits (other than benefit accruals relating to the period of qualified military service) provided under the plan. For example, if a plan provides for accelerated vesting or special or increased benefits for participants who die while actively employed, such benefits must be provided for employees who die while performing qualified military service. This provision applies to deaths occurring on

or after January 1, 2007, but formal plan amendments are not required until the last day of the 2010 plan year (2012 for governmental plans).

- *Differential Pay Treated as Plan Compensation and as Wages for Withholding.* Under the HEART Act, employers that continue to pay their employees who are serving in the uniformed services (as defined in USERRA) must treat such payments as compensation for retirement plan purposes and wages for income tax withholding purposes but only to the extent the payments are "differential wage payments." "Differential wage payments" is defined as payments made to an individual during any period of military service of more than 30 days that represents all or a portion of the salary or wages the individual would have received if performing services for the employer. These provisions apply to differential pay provided after December 31, 2008 (for withholding purposes) and to plan years beginning after December 31, 2008 (for plan compensation purposes), but formal plan amendments are not required until the last day of the 2010 plan year (2012 for governmental plans).

- *Participants on Active Military Duty for More Than 30 Days May Withdraw Tax-Deferred Contributions.* The HEART Act requires 401(k) and other elective contribution plans to treat employees who are on active military duty for more than 30 days as having terminated employment for purposes of taking a distribution of tax-deferred contributions. (Note: This provision applies even if an employee is considered to be actively employed by virtue of receiving differential pay during such leave.) An employee who takes such a distribution will still be subject to the 10% early withdrawal penalty, unless the employee qualifies for the waiver of the penalty for distributions to qualified reservists described below. Elective contribution plans must also provide that any individual who elects to take such distribution may not make any elective deferral or after-tax contributions during the six-month period beginning on the date of such distribution. This provision applies to plan years beginning in 2009, but formal plan amendments are not required until the last day of the 2010 plan year (2012 for governmental plans).

Mandatory provision that does not require a plan amendment, but that must be administered for employees called to active duty on or after December 31, 2007:

- *Permanent Waiver of 10% Early Withdrawal Penalty on Distributions to Qualified Reservists Called to Active Duty For At Least 180 days.* The HEART Act makes permanent the waiver of the 10% early withdrawal penalty for qualified reservist distributions. (This waiver was originally enacted by the Pension Protection Act of 2006 for qualified reservist distributions made to employees called to active duty before December 31, 2007.) Qualified reservist

distributions are distributions from an IRA, 401(k) plan, or 403(b) plan to reserve members called to active duty for more than 179 days, or an indefinite period, that are made during the period beginning on the date of such call and ending at the close of the active duty period. No plan amendment is required, but this rule must be administered for employees called to active duty on or after December 31, 2007.

Optional provisions that plan sponsors may elect to incorporate into their plans:

- *Accrual of Pension Rights and Benefits for Employees Who Die or Become Disabled During Qualified Military Service.* Under the HEART Act a qualified plan (including 401(k), 403(b), 457(b), and SEP-IRA plans) may treat participants who die or become disabled while performing qualified military service as if the participant became reemployed on the day preceding death or disability, then terminated employment the following day. The purpose of this provision is to allow employers to credit participants who die or become disabled during military service with the pension rights and benefits which would have accrued upon the participants' reemployment with the employer under USERRA. (USERRA requires that such rights and benefits be provided, but only if an employee returns to employment following the completion of military service.) If an employer elects to apply this optional provision, the plan must be amended by the last day of the 2010 plan year (2012 for governmental plans). Further, such amendment must provide that the pension rights and benefits are provided to all employees who perform military service on a reasonably equivalent basis (i.e., such rights and benefits cannot be provided only to highly

compensated employees) and that to the extent that such rights and benefits are contingent upon elective deferrals and/or employee contributions, the rights and benefits provided must be based on the participant's average elective deferrals and/or employee contributions during the 12-month period (or, if less, the employee's actual period of service) immediately preceding the period of military service. Such amendment applies to deaths or disabilities occurring on or after January 1, 2007, or such later effective date set forth in the plan amendment.

- *Tax-Free Distributions from Health FSAs to Qualified Reservists Called to Active Duty for at Least 180 Days.* Under the HEART Act, health flexible spending account plans *may* permit distributions of all or a portion of the balance of an individual's Health FSA to reserve members called to active duty for more than 179 days, or an indefinite period, that are made during the period beginning on the date of such call and ending on the last day that reimbursements could otherwise be made under such arrangement for the plan year that includes the date of such call. (It is not yet clear whether this means the end of the plan year, the end of the 2½ month grace period, or the end of the claims period.) If an employer elects to implement this optional provision, it must be administered for distributions made on or after June 17, 2008. (The HEART Act does not clearly explain how these distributions should be administered. The IRS is aware of this and likely will issue additional guidance clarifying administration of these distributions in the near future.)

For more information about the effect of the HEART Act on your company's employee benefit plans, please contact your Seyfarth Shaw attorney, or any Employee Benefits attorney on our website (www.seyfarth.com/EmployeeBenefits).

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