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Impact of the Heroes Earnings Assistance and Relief Act of 2008 on Your Employee Benefit Plans

by
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A few days before this summer officially began, President Bush signed into law a congressional bill that provides various forms of valuable financial relief for this country's armed service members. Among the more publicized forms of relief, the "Heroes Earnings Assistance and Relief Tax Act of 2008," or "HEART," makes the recent economic stimulus rebates more widely available to service members and makes permanent the ability to exclude combat pay from gross income for earned income tax credit purposes. HEART also includes various provisions that impact employee benefit plan administration, such as expanding the ability of service members to receive health flexible spending account and qualified plan distributions, and requiring that qualified retirement plans provide increased survivor benefits to survivors of service members who die in active duty. This newsletter explains how HEART's provisions impact sponsors' administration of health FSAs, qualified 401(k) and other retirement plans, and 403(b) tax-sheltered annuities. At the end of the newsletter, we address the plan amendment needs, considerations, and deadlines.

Unused Flexible Spending Arrangement Amounts

HEART recognizes that reservists called to active military service have commonly fallen victim to the cafeteria plan "use-it-or-lose-it" rule. Generally, amounts in an employee's health flexible spending account ("health FSA") not used for medical expenses incurred before the end of a plan year must be forfeited. Since 2005, the IRS has allowed an extended two and one-half month grace period during which expenses may be incurred and paid for by pre-tax contributions made during the preceding plan year. In the case of service members called to duty, however, even the grace period may not have saved them from forfeiting their health FSA balances.

HEART addresses this problem by *allowing* a cafeteria plan or health FSA to make "qualified reservist distributions" that will not jeopardize a plan's status as a cafeteria plan or health FSA (and the associated favorable tax treatment its participants receive). A "qualified reservist distribution" is a distribution of all or a portion of a participant's health FSA balance if: (1) the participant is a reservist called to active duty for a period of at least 180 days or for an indefinite period; and (2) the distribution is made during the period beginning with the call to active duty and ending on the last date reimbursements could otherwise be made for the plan year that includes the date of the call to active duty.

This new relief is effective immediately (that is, it applies to distributions from a health FSA on or after June 17, 2008). As the italicized "*allowing*" suggests above, a plan is not required to make qualified reservist distributions, but an employer may elect for a plan to do so. At the end of this newsletter, we

"HEART permits *a qualified plan, Section 403(b) tax-deferred annuity, or Section 457(b) governmental deferred compensation plan to give special treatment to a service member who cannot be reemployed on account of death or a disability occurring while in qualifying military service."*

discuss why the optional nature of this new rule may argue for the immediate adoption of an amendment to any plan that is to make qualified reservist distributions.

Death or Disability of Participant

***Accrued Benefit and Contributions*.** HEART *permits* a qualified plan, Section 403(b) tax-deferred annuity, or Section 457(b) governmental deferred compensation plan to give special treatment to a service member who cannot be reemployed on account of death or a disability occurring while in qualifying military service. More specifically, a plan may (but is not required to) treat such an individual as if he or she had been rehired as of the date of death or disability and then had terminated employment on the date of death or disability. With respect to such a "deemed rehired employee," the plan is then permitted to fully or partially comply with the benefit accrual restoration provisions Tax Code Section 414(u) would have imposed had the individual actually been rehired. Those restoration provisions generally require that a plan count a reemployed veteran's uniformed service for vesting and benefit accrual service purposes (for defined benefit and defined contribution plans – such as a profit-sharing plan – alike), and that the employer bear any corresponding funding obligation. The provisions also entitle the reemployed veteran to any accrued benefits (such as matching contributions) that are contingent on the making of, or derived from, employee contributions or elective deferrals, so long as the reemployed veteran pays to the plan those contributions and deferrals during a specified period following reemployment (generally three times the period of uniformed service, but not to exceed five years). During that same period, reemployed veterans are also permitted to make additional elective deferrals or employee contributions.

If a plan chooses to apply the special "deemed rehired employee" treatment, it must satisfy a couple of requirements to ensure the benefits are credited on a nondiscriminatory basis. First, all employees of the sponsoring employer who die or become disabled while performing qualified military service must be credited with benefits on a reasonably equivalent basis. This does not prevent different levels of compensation from resulting in differences in credited benefits, but it does prevent the plan from fully complying with Section 414(u) with respect to highly compensated employees and complying only partially (or not all) with respect to nonhighly compensated employees. Second, if a deemed rehired employee will receive benefits that are contingent on employee contributions or elective contributions, the plan must determine the rate of employee contributions or deferrals on the basis of the actual average contributions or deferrals the employee made during the 12-month period prior to military service (or if the employee had not worked 12 months for the employer, the average for the actual period of service).

The "deemed rehired employee" treatment is retroactively permissible with respect to deaths and disabilities occurring on or after January 1, 2007. In general, a plan electing to apply the treatment must be amended accordingly on or before the last day of the plan year beginning on or after January 1, 2010 (2012 for governmental plans). Please see the end of this newsletter for additional commentary regarding the amendment deadline.

Survivor Benefits. HEART *requires* that qualified plans, Section 403(b) tax-deferred annuities, and Section 457(b) governmental deferred compensation plans afford special treatment to survivors of a plan participant who dies while performing military service. Those survivors must be entitled to any additional benefits the plan would have provided if the participant had resumed employment with the employer maintaining the plan and then terminated employment on account of death. For example, some plans provide for accelerated vesting or ancillary life insurance benefits that are contingent upon a participant's termination of employment because of death. HEART requires that any such additional benefits be provided to the beneficiary of a participant who dies during

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qualified military service. Notably, the relevant "additional benefits" do not include benefit accruals relating to the period of qualified military service.

This requirement is also effective with respect to deaths occurring on or after January 1, 2007, and, as we discuss in detail at the end of this newsletter, must be reflected via plan amendment no later than the last day of the plan year beginning on or after January 1, 2010 (2012 for governmental plans).

Plan Treatment of Differential Military Pay

Some employers voluntarily agree to pay an employee in active duty the difference between (i) the compensation he or she would have received from the employer but for active military duty and (ii) compensation received for military duty. Prior to HEART, this "differential pay" did not receive full treatment as "wages" or "compensation," which had consequences for plan participants. For example, it was not included in the definition of "wages" for Federal withholding tax purposes, because the service member was treated as having terminated his or her employment relationship. Service members, instead, received a Form 1099-MISC and were forced to pay all taxes on differential pay. Further, it was not required to be included as "compensation" under Tax Code Section 415's annual benefit limitations (though 2007 final regulations now *permit* a plan to treat differential pay as compensation for 415 purposes).

HEART addresses and eliminates both of those consequences. First, it amends the definition of "wages" subject to Federal income tax withholding to include a "differential wage payment," with respect to amounts paid after December 31, 2008. To be included in the amended definition, differential pay must be: (1) paid 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) represent all or a portion of the wages that the individual would have received from the employer if the individual were performing services for the employer.

Second, the differential wage payment is required to be treated as compensation for retirement plan purposes. This, in turn, implicates the Tax Code's nondiscrimination requirements. HEART prescribes the following safe harbor. A retirement plan will not be treated as failing to meet applicable nondiscrimination requirements by reason of any contribution or benefit based on the differential wage payment if all of the sponsoring employer's employees: (i) are entitled to differential wage payments on reasonably equivalent terms; and (ii) if all employees eligible to participate in the retirement plan are entitled to make contributions based on such differential payments on reasonably equivalent terms.

This HEART change becomes effective with respect to differential pay paid on or after January 1, 2009. An existing plan or annuity contract need not be amended accordingly until the last day of the first plan year beginning on or after January 1, 2010 (2012 for governmental plans), as we discuss later.

Distributions to Service Members

In-Service Distributions? Certain types of retirement plan contributions are subject to restrictions that generally limit distributions to a participant prior to severing employment with the sponsoring employer. Such contributions include 401(k) plan elective deferrals, as well as 403(b) tax-sheltered annuity salary reduction amounts and amounts deferred under a Section 457(b) eligible deferred compensation plan.

HEART modifies those restrictions in a manner expected to assist service members and their families in cash-strapped situations. An individual will be considered to have severed from employment (and, thus, any resulting distribution will not be a prohibited in-service distribution of the contributions

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listed above) during any period in which the individual is performing uniformed service while on active duty for a period of more than 30 days. Note that if any amounts are distributed on account of this new rule, the individual will not be permitted to make elective deferrals or employee contributions to the plan during the six-month period beginning on the date of distribution. Also note that service members are receiving the best of both worlds with regard to whether they have severed from employment. That is, they are considered to sever employment so as to avoid in-service distribution restrictions, but not for the purpose of receiving a Form 1099-MISC and owing self-employment taxes (as described in the previous section).

Early Withdrawal Penalty Relief. HEART also made permanent the Pension Protection Act of 2006 ("PPA '06") relief from the 10-percent early withdrawal tax that would have expired on December 31, 2007. Subject to certain exceptions, an individual who receives a qualified retirement plan taxable distribution prior to the earliest of age 59 1/2, death, or disability is generally subject to a 10-percent early withdrawal penalty tax. PPA '06 provided that "qualified reservist distributions" to individuals ordered or called to active duty after September 11, 2001, and before December 31, 2007, were excepted from the 10-percent penalty tax. A "qualified reservist distribution" is a distribution made: (i) from an IRA or attributable to elective deferrals under a section 401(k) plan, section 403(b) annuity, or certain similar arrangements; (ii) to a reservist who was ordered or called to active duty for a period of at least 180 days or an indefinite period; (iii) during the period beginning on the date of the order or call to duty and ending at the close of the active duty period. HEART makes permanent the PPA '06 rule, including its applicability from December 31, 2007 (when it had expired), to June 17, 2008 (when HEART became law).

Rollover to IRA. An individual who receives a "qualified reservist distribution" may, at any time during the two-year period beginning on the day after the end of the active duty period, make one or more contributions to his or her IRA in an aggregate amount not to exceed the amount of the distribution. The dollar limitations otherwise applicable to contributions to IRAs do not apply to any contribution made pursuant to this special contribution rule. HEART also makes permanent this special contribution rule.

Mental Health Parity

Until December 31, 2007, the Tax Code, ERISA, and Public Health Service Act imposed mental health parity requirements on group health plans that provide both medical and surgical, and mental health, benefits. That is, such a plan could not impose lifetime or annual limits on mental health benefits that did not also apply to substantially all medical and surgical benefits. Also, an excise tax applied in the event a plan failed to meet those requirements ($100 per day, but not to exceed the lesser of 10 percent of the plan's prior year expenses or $500,000). HEART reinstates the requirements and excise tax effective for the period beginning June 17, 2008, and ending December 31, 2008.

Additional Noteworthy Changes

HEART provides service members additional relief that does not directly impact their qualified retirement or flexible spending account plans. Although that additional relief is beyond the intended scope of this article, we want to briefly mention two changes – one that will impact service members' retirement or educational expense saving and another that encourages employers to provide the differential pay discussed in this newsletter. HEART allows an individual who receives a military death gratuity or Servicemembers' Group Life Insurance payment to contribute to a Roth IRA or Coverdell education savings account an amount equal to sum of such amounts, notwithstanding the contribution limits otherwise applicable to Roth IRA or Coverdell education savings account contributions. HEART also provides small employers (averaging less than 50

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"The permissive/optional changes [related to qualified plans] . . . , however, may argue for more immediate attention if your company desires to utilize those new provisions. This, like in the health FSA context discussed above, would allow your company to clarify which new provisions will indeed be utilized and the manner in which they will be administered."

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employees during the taxable year) incentive to provide differential pay to service members through a new tax credit equal to 20 percent of the sum of all differential wage payments in a taxable year. This tax credit may make small employers more capable of providing all employees the reasonably equivalent differential pay necessary to satisfy the nondiscrimination requirements described above.

HEART also includes special rules applicable to various employee benefit plans when certain U.S. citizens relinquish their citizenship or certain long-term U.S. residents terminate their residency. Those certain individuals – defined as "covered expatriates" – are those who: (i) have relatively high tax liability (a five-year average of at least $139,000 in 2008); (ii) have relatively high net worth ($2 million or more); or (iii) either not have certified under penalties of perjury that they have complied with all U.S. federal tax obligations for the previous five years or not have submitted the requisite evidence of compliance. Very generally, a qualified plan administrator must withhold a special 30 percent withholding tax from any plan payment to a covered expatriate that would be includible in gross income if he or she were subject to U.S. federal income tax. Additionally, a covered expatriate with an interest in any of the following accounts is considered to receive a distribution of his or her entire account on the day before the expatriation date: Section 529 qualified tuition plan, Coverdell education savings account, health savings account, Archer medical savings account, and IRA or individual retirement annuity. This paragraph includes an overly general description of the applicable rules and terms. If you have any questions about employees who may be considered covered expatriates, please let us know.

Plan Amendments

Health FSA. A health FSA could begin to make "qualified reservist distributions" as early as June 17, 2008. If your company desires to make those distributions, we suggest that plan documents be amended, and SPDs revised or SMMs distributed, as soon as possible. Those steps will memorialize and clarify the intent to make the distributions and the mechanics for doing so. For example, will the participant be required to apply for the distribution, or will the plan provide for an automatic distribution? And, if the distribution will be automatic, will it be made on the last day of the "run-out" period or at some specified earlier date? In the absence of federal law requirements to make – and how to make – qualified reservist distributions, we believe employers would be best-served by having the applicable rules in writing.

Qualified Retirement Plans. As mentioned throughout the newsletter, HEART provides a delayed amendment deadline for its provisions impacting retirement plans. Importantly, however, in order for a retroactive amendment to later be permissible, the plan must have been administered in a manner consistent with the HEART provision since the provision became effective. For the mandatory changes (those related to survivor benefits and compensation definitions), employers may be more inclined to take their time in adopting amendments – so long as necessary administrative changes are made. The permissive/optional changes (the "deemed rehired employee" rules and prohibited in-service distribution relief), however, may argue for more immediate attention if your company desires to utilize those new provisions. This, like in the health FSA context discussed above, would allow your company to clarify which new provisions will indeed be utilized and the manner in which they will be administered.

Closing

HEART has been warmly received as positively impacting service members' ability to receive economic stimulus checks, qualify for the earned income tax credit, obtain mortgage relief, and, as explained in this newsletter, receive some of the employee benefits and associated favorable tax consequences they would have received if they had not been called to defend our country.

Employers need to be aware of HEART's impact on employee benefit plans and ensure that administrative practices and plan documents reflect the appropriate changes at the appropriate time. If you have any questions regarding those issues, please do not hesitate to contact any of our firm's attorneys.

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