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HEART Support for Our Troops Will Affect Employee Benefit Plans

by Charles. M. Cain II and Gordon Earle Nichols

Earlier this spring, Congress passed the Heroes Earnings Assistance and Relief Tax Act of 2008 (the "Act"), commonly referred to as the HEART Act, which was signed into law by President Bush on June 17, 2008. The Act addresses several different operational issues arising under private sector benefit plans in which employees called into active duty participate. All employers should review these new rules and consider the impact on their employee benefit plans.

Differential Wage Payments

Generally, a "differential wage payment" is compensation paid by an employer that represents all or a portion of the wages the employee called into active duty would have received from the employer if the employee was, instead being in active duty, performing services for the employer, regardless of the employee's legal right to any portion of such payment. For differential wage payments made *after* December 31, 2008, the Act provides that such payments made to individuals who are on active military duty for more than 30 days are subject to income tax withholding. In addition, if an employer makes differential wage payments, they must be treated as "Compensation" under an employer's qualified retirement plan. As a result, differential wage payments must be taken into account for purposes of elective deferrals and employer contributions to any tax-qualified retirement plan.

- Action Item: Payroll systems will need to withhold from differential wage payments made to employees in active duty made for more than 30 days. The definition of "Compensation" in most tax-qualified retirement plans will likely need to be amended to include differential pay. Although amendments are not required until the last day of the first plan year beginning on or after January 1, 2010, it is advisable for administrative purposes to have the language in the plan by the beginning of next year.

Benefit Accruals

The Uniformed Services Employment and Reemployment Rights Act ("USERRA") provides that tax-qualified plans **must** recognize qualified military service of those employees who return to work after completing such service for vesting and benefit accrual purposes. Under USERRA, employees returning from qualified military service **may** make catch-up contributions to a tax-qualified retirement plan (up to the amount the individual could have made if the individual had remained employed) within a period equal to the lesser of (i) three times the length of the qualified military service or (ii) five (5) years. If an employee makes such contributions, the employee is entitled to accrued benefits that are contingent on employee contributions (e.g., employer matching contributions).

However, under the Act, qualified plans also **may** (but are not required to) recognize qualified military service for benefit accrual purposes for employees who do not return to employment with the plan sponsor due to death or disability. If a plan provides such crediting, it must do so on a reasonably equivalent basis for all employees who die or become disabled while performing qualified military service. For the purpose

of crediting accruals under the Act, the employee will be treated as having made employee contributions during the military service equal to the employee's average rate of contributions for the 12-month period immediately prior to the military service or the actual length of continuous service with the employer (if the period is less than 12 months). As with the survivor benefits provisions, a plan **may** recognize military service for benefit accrual purposes for any deaths or disabilities occurring on or after January 1, 2007. Again, plan amendments are not required until the last day of the first plan year beginning on or after January 1, 2010.

- Action Item: For plan sponsors who want to recognize qualified military service for benefit accrual purposes for employees who do not return to work due to death or disability, a plan amendment will be required. Although plan amendments are not required until the last day of the first plan year beginning on or after January 1, 2010, a plan sponsor may want to amend its plan currently and begin providing for such accrual.

Distributions from Health Flexible Benefits Plans

The Act amends Internal Revenue Code ("Code") Section 125 to permit health care flexible spending arrangements ("Health FSAs") in cafeteria plans to allow "qualified reservist distributions" for employees called into active military service for a period of at least 180 days or an indefinite period. A qualified reservist distribution may be made during the period beginning on the date of the order calling the employee into military service and ending on the last date that reimbursement could be made for the plan year that includes the date of such order. Although plans **may** permit qualified reservist distributions beginning on January 1, 2008, employers may wish to wait for clarification on several issues not addressed in the Act. Specifically, it is unclear whether (1) such distributions will be subject to income tax withholding requirements, and (2) the amount of the distributions will be limited to the employee's remaining balance in the Health FSA account.

- Action Item: Pending the issuance of future guidance, plan sponsors may want to review their cafeteria plans in order to determine if they want to provide for qualified reservist distributions. This will likely require a plan amendment and a summary of material modifications to notify participants accordingly.

Survivor Benefits

The Act provides that, as a qualification requirement under the Code, survivors of a tax-qualified retirement plan participant who dies while performing qualified military service **must** be entitled to any additional benefits (other than accruals related to the time period of such military service) provided under the plan as if the participant had died while employed by the employer. Many plans provide accelerated vesting or ancillary life insurance benefits for participants who die while actively employed by the plan sponsor. Under the Act, these types of benefits must also be provided to the survivors of those participants who die during "qualified military service," as defined under Code Section 414(u). Although plan amendments are not required until the last day of the first plan year beginning on or after January 1, 2010, this requirement applies to all individuals who die during qualified military service on or after January 1, 2007.

- Action Item: If you have any employees called into active duty, this issue should be reviewed with the third-party administrator of any plan in which such employees participate to make sure benefits are provided accordingly. Although the plan does not have to be amended until December 31, 2010, at the earliest, this change will affect benefits currently provided under certain plans.

Distributions from Qualified Retirement Plans

Employees who are called into qualified military service (i.e., called into active duty for more than 30 days) **must** be treated as having a severance from employment and be permitted to take a distribution of elective deferrals from a tax-qualified retirement plan. However, if an employee takes such a distribution, the employee **must** be suspended from making elective deferrals for a six-month period beginning on the date of the distribution. The Act also makes permanent the exemption from the 10% early withdrawal penalty in

the Pension Protection Act of 2006 for employees called into active military service for a period of at least 180 days or for an indefinite period.

- Action Item: Although most tax-qualified retirement plans already include distribution provisions for a severance from employment, they will likely need to be amended to include the six-month suspension period following distributions related to qualified military service.

If you have any questions about the HEART Act, please contact one of the Employee Benefits and Executive Compensation attorneys at Boult, Cummings, Conners & Berry PLC:

Martha L. Boyd
615.252.2357
mboyd@boultcummings.com

Charles M. Cain II
615.252.2330
ccain@boultcummings.com

Andrew Elbon
615.252.2378
aelbon@boultcummings.com

B. David Joffe
615.252.2368
djoffe@boultcummings.com

Gordon Earle Nichols
615.252.2387
gnichols@boultcummings.com

John M. Scannapieco
615.252.2352
jscannapieco@boultcummings.com

Roundabout Plaza, 1600 Division Street, Suite 700 Nashville, TN 37203
615.244.2582 www.boultcummings.com