

THE HEART ACT—ENHANCED BENEFITS FOR MILITARY SERVICE AND NEW IRS GUIDANCE FOR HEALTH FSA DISTRIBUTIONS

The Heroes Earnings Assistance and Relief Tax (“HEART”) Act (P.L. 110-245) was signed into law on June 17, 2008. The HEART Act requires or permits the following changes to retirement and other employee benefit plans with respect to employees who are called into qualified military service (as defined in I.R.C. § 414(u)):

- mandatory death benefits;
- permissive disability benefits;
- permissive benefit accrual (for death and disability benefits) while in qualified military service;
- mandatory recognition of differential pay for federal income tax withholding;
- permissive recognition of differential pay for retirement plan purposes;
- permanent extension of favorable tax rules for qualified reservists distributions;
- access to 401(k), 403(b) and eligible 457(b) deferrals; and
- access to unused health flexible spending account balances.

1) **Mandatory Death Benefits and Permissive Benefit Accruals.** The HEART Act adds I.R.C. § 401(a)(37) to provide “death benefits while in USERRA-qualified active military service,” as a plan qualification requirement. I.R.C. § 401(a)(37) reads (in part) as follows: “in the case of a participant who dies while performing qualified military service (as defined in Code Section 414(u)), the survivors are entitled to any additional benefits (other than benefits related to the period of qualified military service) provided under the plan had the participant resumed and then terminated employment on account of death.” I.R.C. § 414(u)(9) has also been added to the Code to provide that “for benefit accrual purposes an employer sponsoring a retirement plan *may* treat an individual who dies or becomes disabled (as provided under the terms of the plan) while performing qualified military service had resumed employment (in accordance with USERRA) on the day preceding death or disability and then terminated employment on the actual date of death or disability.” A similar mandate has been added to the Code with respect to 403(b) plans [I.R.C. § 403(b)(14)] and 457(b) plans [I.R.C. § 457(g)(4).] The employer may choose either partial or full benefit accruals, and the benefits must be applied to all similarly situated individuals in a similar manner. These provisions apply to a death or disability occurring on or after January 1, 2007. I.R.C. § 414(u)(9) includes a provision that the amount of employee contributions or elective deferrals of a participant treated as reemployed (the day before death or disability) shall be based on actual earnings during the 12-month period immediately preceding the qualified military service (or if such service is less than 12 months, the actual period of continuous service).

Thus, 401(k) and other contributory defined contribution and defined benefit plans *may* deem elective deferrals and/or employee contributions to have been made during the

period of qualified military service prior to the participant's death or disability. The legislative history indicates that, if a plan provides for accelerated vesting, ancillary life insurance and other survivor benefits which are contingent on a participant's death, the plan *must* provide such benefits to the beneficiary of a participant who dies during qualified military service.

Comment: I.R.C. § 414(u)(9) is silent with respect to whether the period of qualified military service in the case of mandatory death benefits or permissive disability benefits must be counted for vesting purposes. Because such vesting service may be required to qualify for death or disability benefits, this issue should be addressed in Treasury Department Regulations or other guidance as soon as reasonably practicable.

- 2) **Differential Pay.** The HEART Act adds I.R.C. § 3401(h) to *require* federal income tax withholding from "differential wage payments to active duty members of the uniformed services," effective January 1, 2009, and adds I.R.C. § 414(u)(12) to *permit* qualified retirement plans to recognize differential pay for contribution or benefit purposes, effective for plan years beginning after December 31, 2008, subject to a nondiscrimination standard that requires reasonably equivalent differential pay for all employees. Furthermore, differential wage pay is treated as compensation for IRA purposes.

Comment: In a final average pay defined benefit retirement plan, the recognition of differential pay could reduce benefits. This and the HEART Act provisions relating to permissive benefit accruals for death and disability benefits during a period of qualified military service, may explain why the recognition of military differential pay for qualified retirement plan purposes is permissive, not mandatory.

- 3) **Qualified Reservists Distributions Made Permanent.** I.R.C. § 72(t)(2)(G)(iv) was added to the Code in the Pension Protection Act of 2006 to exempt qualified reservist distributions by an individual called or ordered to active duty for at least 180 days from the ten percent (10%) excise tax penalty on premature withdrawals or salary deferral amounts in a 401(k), 403(b) or eligible 457(b) plans, provided the individual was ordered to active duty after September 11, 2001 and before December 31, 2007. The HEART Act simply deleted "and before December 31, 2007" from I.R.C. § 72(t)(2)(G)(iv) and made these qualified reservists distribution provisions permanent.
- 4) **Distributions of Salary Deferrals from 401(k), 403(b) and Eligible 457(b) Plans.** Beginning January 1, 2009, a plan participant called to active military duty for more than 30 days will be treated as having severed from employment for the purpose of receiving a distribution of salary deferrals or employee contributions from a 401(k), 403(b) or eligible 457(b) plan, subject (beginning on the date of distribution) to a 6-month suspension of the ability to make salary deferrals or employee contributions to the plan.

Comment: Whether this special distribution provision applies to the earnings on the salary deferral or employee contribution accounts is not addressed in either I.R.C. § 414(u)(12)(B) or the legislative history. Furthermore, whether this special distribution rule is limited to distributions of military differential pay is not clear. Presumably, it is

not limited to military differential pay because it applies to a plan participant called to active duty for more than 30 days, rather than at least 180 days. Both of these questions should be addressed in Treasury Regulations or other guidance.

5) **Access to Unused Health Flexible Spending Account Balances.** The HEART Act also amends I.R.C. § 125 to permit a cafeteria plan to make a qualified reservist distribution of all or a portion of an unused health flexible spending account (“Health FSA”) in a cafeteria plan, provided the participant has been ordered or called to active duty for at least 180 days and the distribution is made on or after the date of the order or call to active duty and before the last day of the plan year that includes such order or call.

On September 29, 2008, IRS issued Notice 2008-82 to provide that such Health FSA distributions:

- are voluntary;
- may be made after June 18, 2008 and in 2009 through the end of the grace period for each year, if applicable, provided a retroactive amendment authorizing such distributions is adopted by December 31, 2009; and
- will be included in the participant’s income, subject to employment taxes, and reportable to the IRS on the participant’s Form W-2 for the year in which the distribution is made.

Employer Actions:

Employers should modify plan operations and employee communications to comply with the HEART Act. Health FSA amendments for retroactive 2008 and 2009 qualified reservist distributions must be adopted by December 31, 2009. Other plan amendments must be made by the last day of the 2010 plan year (or, in the case of governmental plans, the last day of the 2012 plan year). The better practice would be to make plan amendments sooner.

For more information, please contact Haynes Benefits PC at 816-875-1919 or visit
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