

Over the next two years, the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART) requires changes in employee benefit plan operations and amendments to qualified retirement plans for the nation's servicemembers. This article summarizes what employees must do for compliance. Withholding issues for certain businesses employing foreign nationals and/or U.S. nationals through related foreign entities are also discussed.

Take HEART:

Plan Operational Changes and Amendments Required

by Kirk A. Pelikan

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In mid-2008, President Bush signed the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART).¹ HEART requires employers to change certain employee benefit plan operations and to amend qualified retirement plans over the next two years. HEART permits, but does not require, employers to make other employee benefit changes that Congress believes supports the nation's service members. This article summarizes HEART's affect on employee benefit plans. Some withholding issues that may arise for certain businesses em-

ploying foreign nationals and/or U.S. nationals through related foreign entities are also discussed.

Required Changes

Survivor Benefits

Employers must amend certain retirement plans (401(k), 403(b) and 457(b) plans) to provide survivors of service member plan participants with the same benefits that the plan pro-

vides to survivors of other employees whose employment is terminated by death. Such benefits may include accelerated vesting or ancillary life insurance benefits. Although this benefit is retroactively effective to January 1, 2007, employers have until the last day of the plan year beginning on or after January 1, 2010 (2012 for governmental plans), to adopt plan amendments addressing the change.

Differential Payments Treated as Wages

Some employers subsidize compensation paid to service members by the military so that the service member does not lose income while in military service. This is known as a differential payment. Employers must now treat differential payments as wages when two conditions are met. First, the payment is made to a service member on active duty for a period of more than 30 days. Second, the differential payment represents wages the service member would have received from the employer had he or she been working for the employer instead of being on active duty. Differential payments are now treated as wages for withholding purposes.

For plan years beginning on or after January 1, 2009, a plan must allow service members to defer differential payments to a retirement plan. Also, the plan must treat service members who do so as employees for nondiscrimination testing purposes. Absent an exclusion, such treatment could potentially cause the plan to fail the test. HEART states that differential payments provided to service members on reasonably equivalent terms (i.e., in a nondiscriminatory manner) will not cause the plan to fail minimum participation and nondiscrimination standards. Unless an employer's plan contains a provision restricting deferral of differential payments, no amendment is necessary to address this issue.

HEART clarifies that even though the differential payment is made to an individual treated as an employee, it does not preclude the service member from taking a retirement plan distribution due to severance from employment. For plan years beginning on or after January 1, 2009, HEART bars service members who take a distribution from making elective deferrals or employee contributions to the plan for six months following the date of distribution. Employers must amend

plans to incorporate this distribution requirement by the last day of the first plan year beginning on or after January 1, 2010 (2012 for governmental plans).

HEART clarifies that even though the differential payment is made to an individual treated as an employee, it does not preclude the service member from taking a retirement plan distribution due to severance from employment.

Further, HEART permits small business employers (employers with an average of fewer than 50 employees in a taxable year) who have a written plan that provides differential payments to service members to credit 20% of the differential pay against the employer's tax liability. The credit does not appear to be available for large employers.

Permissive Changes

Treating Service Member as Reemployed Prior to Death or Disability

Unlike their reemployed counterparts, employees who are not reemployed under the Uniformed Services Employment and Reemployment Rights Act (USERRA) do not receive credit toward certain benefits—for example, years of service—for the time they are on military duty. Service member employees who die or are disabled during military service may not be qualified for reemployment with the employer under USERRA.

Under HEART, retirement plans are permitted to treat service members who die or are disabled while performing uniformed service as having been reemployed on the day before death or disability and subsequently as having terminated employment on the date the service member died or was disabled. If implemented, the change preserves the employee's service credit for benefit purposes. HEART requires employers that

implement the amendment to enforce it uniformly. An employer cannot provide a full benefit to its highly compensated service members and a partial benefit to its nonhighly compensated service members. Where the benefit is contingent on employee contributions or deferrals, the plan benefit must be paid based upon the amount the service member contributed or deferred during the 12 months preceding the service member's departure for service.

Qualified Reservist Distributions

The Internal Revenue Code generally penalizes early withdrawals from retirement plans by imposing a 10% excise tax on participant withdrawals prior to age 59½. The Pension Protection Act of 2006 created a temporary exemption for certain service members from the penalty where the service member was ordered to active duty for a period greater than 179 days, provided the distribution occurred during the period of active duty. The exemption originally expired on December 31, 2007. HEART has brought the exemption back and made it permanent.

HEART also permits distributions from flexible spending accounts (FSAs). In general, money contained in an FSA must be used in the calendar year of contribution for a qualified purpose or it will be lost. If the FSA refunds contributed money, the plan will lose its tax-qualified status. HEART permits, but does not require, an employer to amend its FSA to allow distribution to reservists called to active duty without losing qualified status. For employers that choose to do so, the IRS released guidance to assist employers and plan administrators to determine whether a reservist is eligible for a qualified distribution from his or her FSA.²

A participant in a plan that allows a qualified reservist distribution must satisfy two requirements to obtain the distribution. First, the participant must be a reservist called to active duty for a period of at least 180 days or for an indefinite period. Employers must request documentation substantiating that the participant satisfies this requirement. The IRS directs that documentation will consist of a copy of the order or call to active duty that specifies the period of leave. If the docu-

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mentation is for less than 180 days, the distribution is not permitted. However, participants subject to an extension of active duty that causes the duration of leave to exceed 180 days subsequently will qualify for the distribution.

Second, the distribution must be made during the period beginning with the call to active duty and ending on the last day of the cafeteria plan's plan year (including grace period, if applicable) in which the participant was called to active duty.

Other Issues

Mental Health Parity Act Extended

HEART extended the Mental Health Parity Act (MHPA) through December 31, 2008. MHPA requires a group health plan provide the same aggregate and annual limits to mental health benefits as are provided to medical and surgical benefits.

Subsequently, Congress passed the 2008 Extenders Act (as part of the general bailout bill to deal with the subprime mortgage crisis). The Extenders Act made MHPA permanent and expanded its scope.³ Now for plan years beginning on or after October 4, 2009 (or such other time which applies to plans maintained pursuant to a collective bargaining agreement), employers must ensure parity exists between the coverage for medical and surgical benefits and, if provided, mental health and substance-use disorder benefits.

Withholding Treatment of Deferred Compensation of U.S. Ex-Patriots

HEART imposes on employers new withholding obligations for deferred compensation plans of certain individuals who expatriate from the United States on or after June 17, 2008. Expatriation involves renunciation of U.S. citizenship or the abandonment or loss of lawful permanent resident status. These obligations will affect only individuals with average income greater than \$124,000 for the five years preceding expatriation or a net worth of at least \$2 million, or individuals who do not certify that they have satisfied

all applicable U.S. tax obligations for the five years before expatriation. The specific rules are not within the scope of this article. Employers that believe they may have an expatriate issue along these lines should seek counsel to discuss further.

Foreign Affiliates of U.S. Companies Performing Service Under U.S. Government Contract Must Withhold FICA From U.S. Citizen/Resident Employees

HEART mandates that foreign companies withhold Federal Insurance Contribution Act (FICA) tax from any U.S. citizen/resident employee working for the foreign company when the following conditions are met: (i) the foreign company is part of a controlled group of entities with a U.S. parent company (the controlled group standard for this rule requires that the parent has more than 50% ownership); (ii) one of the companies in the controlled group has a contract with the U.S. government; and (iii) the foreign entity's U.S. citizen/resident employee performs services in connection with the government contract. The foreign entity is required to file all returns associated with this tax. HEART makes the U.S. parent jointly and severally liable for this obligation. This provision took effect on July 17, 2008.

Next Steps

What are the implications of the

HEART Act and the 2008 Extenders Act? Employers must:

- Review retirement plan documents to ensure the documents contain: (i) the provision of equivalent benefits to survivors of service members as those provided to other survivors; and (ii) restrictions on deferrals and contributions for six months following a distribution from the plan. Amendments must be adopted by 2010 (or 2012 for governmental plans); however, employers need to comply sooner.
- Decide whether optional provisions are desirable additions to the plan. If so, amendments to add these provisions must be adopted.
- Communicate changes to participants and revise the summary plan description.
- Review payroll practices and ensure proper withholding if they provide differential pay or are involved in foreign operations, e.g., joint ventures.

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Endnotes

1. Pub. L. No. 110-245.
2. IRS Notice 2008-82 (Sept. 29, 2008).
3. Emergency Economic Stabilization, Energy Improvement and Extension, and Tax Extenders and AMT Relief Acts of 2008, Pub. L. 110-343.

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Kirk A. Pelikan is a member of the Employee Benefits Practice Group at Michael Best & Friedrich LLP in Milwaukee, Wisconsin. Pelikan represents and advises clients regarding defined benefit, defined contribution and welfare benefit plans. He also represents clients in employment issues including USERRA. He received his J.D. from Marquette University Law School.

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