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Passage of HEART Act Impacts Employee Benefit Plans

I. Introduction

The Heroes Earnings Assistance and Relief Tax Act of 2008 (the "HEART Act"), which became law in June 2008, *requires* employers to provide certain benefits to employees who are reservists called to active duty and are killed or disabled while performing their military obligations. The HEART Act also *allows* employers to provide new optional benefits for employees who are called to active duty. This advisory highlights some of the key provisions of the HEART Act applicable to employers. Specifically, it addresses certain changes affecting qualified retirement plans, cafeteria plans and rollovers to Individual Retirement Accounts ("IRAs").

II. Provisions of the HEART Act

Required Expansion of Qualified Plan Survivor Benefits to Fallen Military Members

The HEART Act requires all qualified plans, 403(b) plans and 457(b) plans to treat a participant who dies while performing qualified military service as if he or she resumed employment on the day before death. Consequently, the participant's survivors are entitled to receive any additional benefits (other than benefit accruals relating to the period of qualified military service) that they would have received under the plan if such participant returned and terminated employment on account of his or her death. Furthermore, if the plan changed while the participant was performing military service, the death or disability benefits paid to the participant must reflect any such changes.

Effective Date: This requirement applies to deaths occurring on or after January 1, 2007.

Amendment Date: Plans must be amended to comply by the end of the first plan year that begins on or after January 1, 2010 (January 1, 2012, for governmental plans).

Optional Provision of Qualified Plan Accrual Benefits to Military Members

For vesting and benefit accrual purposes, existing law requires qualified plans to credit service for employees who return to active employment from qualified military service. The HEART Act permits plans to offer benefits accrual to participants who do not return to employment due to a death or disability that occurs while the participant is performing qualified military service. Under this provision, the participant is treated as if he or she returned to work the day before dying or becoming disabled. If an employer elects to provide these accrual benefits, service must be credited on reasonably equivalent terms to all military members who are on active duty.

Effective Date: A plan *may* adopt this provision effective for deaths or disabilities occurring after January 1, 2007.

Amendment Date: If a plan adopts this provision, it must be amended by the end of the first plan year that begins on or after January 1, 2010 (January 1, 2012, for governmental plans).

Differential Wages Are Now Treated as Taxable Wages and as Compensation for Retirement Plan Purposes

One of the most significant burdens on reservists called to active duty is lost income due to the disparity between their civilian and military salaries. Some employers choose to voluntarily make up this difference by making differential wage payments. Historically, military differential pay has not qualified as wages for purposes of withholding income taxes and

employment taxes. The HEART Act provides that differential wage payments made after December 31, 2008, should be treated as wages for federal tax withholding purposes. Consequently, such payments should be reported on Form W-2 rather than Form 1099 for 2009 and later years.

The HEART Act also allows differential wage payments to be included in the definition of compensation for retirement plan purposes. A participant can make an elective deferral based on any differential wages he or she receives, provided that all participants are entitled to receive such payments and make such contributions under reasonably equivalent terms. In addition, employers with fewer than 50 employees who elect to pay differential wages are entitled to a 20% tax credit on up to \$20,000 of differential wage payments for each qualified serviceperson. This credit is available for all payments made between June 18, 2008, and January 1, 2010.

Effective Date: The changes related to differential wages are effective beginning on January 1, 2009.

Amendment Date: Plans must be amended to reflect these changes by the end of the first plan year that begins on or after January 1, 2010 (January 1, 2012, for governmental plans).

Some Early Withdrawal Penalties Lifted for Military Members

The HEART Act makes permanent an exemption, which was temporarily provided by the Pension Protection Act of 2006, that allows reservists called to active duty to make withdrawals from a 401(k) plan, a 403(b) plan or an IRA without paying the 10% penalty on early withdrawals. This exemption applies to reservists called to active duty after September 11, 2001, for a period of more than 179 days or for an indefinite period.

Participants on active duty for longer than 30 days are considered to have been severed from service for purposes of taking a distribution of elective deferrals from a 401(k), 403(b) or 457(b) plan. Any individual who elects to take such a distribution will have to wait six months before making another elective deferral or employee contribution.

Tax-Free Death Benefit Rollovers to a Roth IRA or an Educational Savings Account

The HEART Act allows recipients of a military death gratuity or a payment from the Servicemembers' Group Life Insurance program to roll over the gratuity or payment to a Roth IRA or a Coverdell education savings account on a tax-free basis, notwithstanding any contribution limits that would normally apply to such contributions. These contributions must be made within one year of receiving the benefit or payment.

Effective Date: This provision applies to payments made in connection with deaths that occurred on or after June 17, 2008 (the date the HEART Act was passed). In addition, distributions related to deaths that happened between October 7, 2001, and June 17, 2008, can be contributed until June 17, 2009 (one year after the enactment of the HEART Act).

Distributions from Health Care Flexible Spending Accounts

The HEART Act allows employers to amend their cafeteria plan to permit a reservist who is called to active duty for more than 179 days (or for an indefinite period) to receive a distribution of all or a portion of his or her balance in a health care flexible spending account ("FSA"). Distributions can be made at any time between the period that the participant is called to active duty and the last day of the plan year or any existing grace period.

The purpose of these FSA distributions is to avoid penalizing workers who set aside money for health care costs without having known that they would be called to active duty. Active duty service members generally have no need to draw money from their FSAs because the military provides them with free health care. While immediately available, employers may want to consider holding off on making this optional amendment until further guidance is provided in order to ensure the cafeteria plan's continued qualified status.

III. Action Items

Survivor Benefits and Accrual Benefits Offered Under Qualified Plans: The requirement to expand survival benefits is retroactive to January 1, 2007. Employers should determine whether there are any participants or survivors whose benefits must be adjusted accordingly. Plans must be amended to reflect these changes no later than the last day of the plan year that begins on or after January 1, 2010 (January 1, 2012, for governmental plans).

Employers should also determine whether they want to offer accrual benefits to participants who do not return to employment due to the participant's death or disability while on active duty, and if so, operate and amend the plan accordingly.

Differential Pay: Employers should ensure that their payroll department will conform with the requirement that differential wage payments shall be reported on a Form W-2 with regard to any such payments made after December 31, 2008.

Health FSA Contributions: Employers should decide if they want to amend their health FSA plans to allow reservist employees to recoup contributions they cannot benefit from due to being called to active duty. Employers may want to consider waiting for further guidance regarding the consequences of FSA distributions before making this amendment.

If you have any questions or would like to discuss the HEART Act and its possible implications, please contact any of the attorneys in Katten's Employee Benefits and Executive Compensation Practice.

Attorney

Shannon Skinner Anglin
Andrew E. Bridgman
Gregory K. Brown
William B. Duff
Michael R. Durnwald
Russell E. Greenblatt
Gary W. Howell
Ann M. Kim
Daniel B. Lange
William E. Mattingly
Edward J. Rayner
Kathleen Sheil Scheidt

Direct Dial

312.902.5409
312.902.5509
312.902.5404
212.940.8532
312.902.5697
312.902.5222
312.902.5610
312.902.5589
312.902.5624
312.902.5266
212.940.8515
312.902.5335

Email

shannon.anglin@kattenlaw.com
andrew.bridgman@kattenlaw.com
gregory.brown@kattenlaw.com
william.duff@kattenlaw.com
michael.durnwald@kattenlaw.com
russell.greenblatt@kattenlaw.com
gary.howell@kattenlaw.com
ann.kim@kattenlaw.com
daniel.lange@kattenlaw.com
william.mattingly@kattenlaw.com
ed.rayner@kattenlaw.com
kathleen.scheidt@kattenlaw.com

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KattenMuchinRosenman LLP

www.kattenlaw.com

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WASHINGTON, DC