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LEGAL ALERT



Legal Alert: HEART Act Provides Benefits for Employees Serving in the Military

7/21/2008

On June 17, 2008, President Bush signed the Heroes Earnings Assistance and Relief Tax Act of 2008 (the "HEART Act"). The HEART Act amends the Internal Revenue Code (the "Code") to provide a number of enhanced benefits and incentives to military service members, including reservists and National Guard members who frequently work for civilian employers in addition to their military duties. The employment-related benefits of the Act are described below.

Tax Treatment for Pay Differentials Provided by Employers

The HEART Act specifically addresses differential wage payments that many employers have been providing to employees called to active military duty. Under the HEART Act, pay differentials (generally, payments made by civilian employers to service member employees to offset any wage loss suffered by the employee as a result of a military activation greater than 30 days) made after December 31, 2008, are to be treated as wages subject to withholding. Consequently, employers providing pay differentials to service member employees need to ensure proper tax withholding from these amounts.

In addition, effective after December 31, 2008, an employee receiving differential wage payments is treated as still being an employee for purposes of employer retirement plans, and the differential wages are treated as "compensation" for purposes of both employer plans and IRAs. At the same time, however, the employee generally is treated as having terminated employment for purposes of permitting the employee to receive certain plan distributions that may not be made while an individual is employed.

Withdrawals from Retirement Plans and Health Flexible Spending Arrangements

The HEART Act makes permanent the ability of reservists who have been activated since September 11, 2001, for 180 days or longer, to make withdrawals from their retirement plans prior to age 59-1/2, while on active duty, without incurring an "early withdrawal" penalty. The reservist may also recontribute the withdrawn amounts to an IRA at anytime within two years after the end of the active duty period, without regard to the otherwise-applicable limitations on IRA contributions. Prior to enactment of the HEART Act, this treatment was limited to military activations occurring after September 11, 2001 and before December 31, 2007. The HEART Act eliminates the December 31, 2007 cut-off date.

Along similar lines, the Act also permits military reservists who are activated for 180 days or longer to withdraw amounts from health flexible spending accounts (FSAs) that would otherwise have been forfeited under the FSA rules, without jeopardizing the arrangement's status under Code Sections 105 or 125. The withdrawal may be made at any time between the date of call-up to active duty and the end of that calendar year (or other coverage period under the FSA).

Killed in the Line of Duty

The HEART Act ostensibly broadens the scope of the pension benefit provision of the Uniformed Services Employment and Reemployment Rights Act ("USERRA"). Under the HEART Act, a service member killed while performing qualified military service is to be treated, for pension purposes, as if he or she returned to employment as of the day before the service member's death, and then died while employed. Survivors and beneficiaries may then be entitled to benefits that would not have been payable without a return to employment. The Act also permits – but does not require – employer-sponsored plans to provide additional benefit accrual, based on the benefit-restoration provisions of USERRA, for service members who are unable to be reemployed due to death or disability, as if they had been reemployed on the day before death or disability. These provisions apply to deaths (or disabilities) occurring on or after January 1, 2007.

"Rollovers" of Death Benefits

Upon the death of a service member, his or her survivors may receive a military death gratuity, or a benefit under the Servicemembers' Group Life Insurance program, or both. The Act permits these benefits, which are both tax-free, to be rolled over into one or more Roth IRAs or Coverdell education savings accounts, without regard to the contribution limits that would otherwise apply. The contributions must be made within one year after receipt of the benefit. This provision generally applies to benefits that are paid by reason of deaths occurring after June 17, 2008. However, beneficiaries may, before June 17, 2009, rollover an amount not exceeding benefits that they received as a result of a service member's death that resulted from injuries incurred on or after October 7, 2001.

A Tax Credit for Small Employers Providing Pay Differentials

One of the most interesting aspects of the HEART Act is that it provides a tax credit for eligible small businesses that provide differential wage payments to certain military service members who are called to active duty. The small business tax credit equates to 20% of any differential wage payments (disregarding payments over \$20,000) made to employees who are on active duty for a period of more than 30 days. A qualified small business under the Act is an employer with an average of fewer than 50 employees during the applicable taxable year and a written military differential wage payment policy applicable to all employees.

This credit is in lieu of a deduction, reduces any other available compensation-based credit, and is a part of the general business credit for purposes of applying the carry-back and carry-forward rules. This tax credit has a sunset provision of December 31, 2009.

Employers' Bottom Line:

The HEART Act provides additional employment-related benefits to military service members. Employers need to be aware of these additional benefits and be prepared to make any necessary plan amendments in accordance with the Act's requirements. If you have any questions regarding the rights and obligations imposed by USERRA or other laws impacting military service members, please contact John Lowrie in our Denver office at jlowrie@fordharrison.com or 303-592-8866. If you have questions regarding the impact of the HEART Act on your employee benefit plans or other benefit related issues, please contact Jeffrey Ashendorf, jashendorf@fordharrison.com, 212-453-5926, in our Employee Benefits and Executive Compensation practice group.