

CLIENT ACTION BULLETIN

June 19, 2008

CAB 08-13

Heroes Earnings Assistance and Relief Tax Act

SUMMARY The "Heroes Earnings Assistance and Relief Tax (HEART) Act" (H.R.6081) passed Congress on May 22 and was signed into law (P.L.110-245) by the President on June 17. The HEART Act provides a broad range of personal and employment-based tax benefits for military personnel and their families. The new law also extends existing mental health parity laws through the end of this year and subjects to Social Security and Medicare taxes those wages paid to employees of certain foreign subsidiaries of U.S. corporations with federal contracts.

DISCUSSION **The HEART Act's key provisions affecting employers with uniformed services personnel include the following:**

- *Penalty-free withdrawals from retirement plans and access to health FSAs*

The law extends the allowance under the Pension Protection Act for active-duty reservists to make withdrawals of their elective deferrals from their retirement plans without having to pay the 10% early withdrawal penalty. This provision originally applied to reservists called to active duty between September 11, 2001, and December 31, 2007. The HEART Act eliminates the December 31, 2007, expiration date, making the "qualified reservist distributions" provision permanent. To qualify, reservists must be called to duty for a period of at least 180 days or for an indefinite period. When they return from active duty, they may recontribute the distribution into an IRA, if contributed within two years of the end of their active duty. However, recontributed amounts are not subject to the IRA limits and are not deductible.

An employer also may extend qualified reservist distributions to allow reservists called to active duty access to their unused funds from health flexible spending accounts (FSAs), starting with distributions made after the date of the law's enactment. The distribution must be made during the period beginning on the date of an order or call to active duty and ending on the last day of the coverage period that includes the date of the call.

- *Additional benefits and accruals for servicepersons killed or disabled on active duty*

The new law requires tax-qualified pension plans to entitle the survivors of plan participants who die or are disabled while on active military duty to the plans' ancillary benefits (i.e., as if the servicepersons returned to work immediately prior to their death or disability and became subject to the current document provisions). Thus, if plan vesting or benefits provisions changed during their military service, the death or disability pension benefits must be updated accordingly. The employer has the option of reflecting the military service for benefit accrual purposes (i.e., for computing the amount of the death or disability pension). However, it is unclear whether reflecting military service for vesting purposes is required or simply an option. This provision is effective for deaths and disabilities occurring on or after January 1, 2007.

- *Treatment of differential wages*

The HEART Act requires that differential wages paid to an employee on active duty for more than 30 days be treated as wages for federal income tax withholding purposes and as "compensation" for retirement plan purposes, effective for remuneration paid after December 31, 2008, and for plan years beginning after December 31, 2008. The retirement plan provision should not adversely impact any nondiscrimination testing or minimum participation standards as long as the differential wages and any employee contributions associated with those wages are granted on "reasonably equivalent terms" to all the employees in the plan.

For purposes of in-service withdrawals with respect to elective deferrals, employees who receive differential wages are treated as having been severed from employment. However, the individual making the withdrawal would not be permitted to make elective deferrals to the plan during the six-month period beginning on the date of the withdrawal.

- *Differential wages tax credit for small employers*

The law offers a tax credit for small employers (i.e., with fewer than 50 employees) that pay differential wages. Such employers are entitled to a 20% tax credit on up to \$20,000 in differential wage payments per qualified serviceperson. The tax credit is coordinated with any other tax credits applicable to qualifying servicepersons and the employer forfeits a portion of the deduction for differential pay. The tax credit is available for amounts paid after the date of enactment and before January 1, 2010.

In other areas, the HEART Act:

- Extends the current-law \$100 per day excise tax on group health plans that impose limits on mental health benefits that are not imposed on medical/surgical benefits. This provision, which amends the Internal Revenue Code, ERISA, and the Public Health Service Act, will be superseded if legislation is later enacted to address mental health parity.
- Modifies the treatment of certain foreign subsidiaries as U.S. employers, classifying them as U.S. employers for purposes of Social Security and Medicare employment taxes. This provision, which is aimed at federal government contractors that circumvent payroll taxes by hiring employees through offshore shell companies, makes the U.S. parent company jointly responsible for paying the foreign subsidiary's employment taxes. The law defines foreign subsidiaries as "domestically controlled foreign persons" with a common U.S. parent. This provision is effective for services performed in calendar months beginning more than 30 days after the law's enactment.

ACTION Employers should take steps to ensure that their employment practices and their benefit programs comply with the new requirements of the HEART Act. For the new law's mandatory benefit plan requirements, amendments must be made by the last day of the plan year that begins on or after January 1, 2010 (2012 for governmental plans). Payroll and other administrative systems may have to be modified to accommodate some of the changes. For example, they should be able to track employees who are: military reservists and therefore could be called up; actively serving in the military; and receiving differential pay. Communications materials should be revised to reflect any required or optional changes made to an employer's pay, employment, and benefits policies and practices.

For additional information about the HEART Act, please contact your Milliman consultant.