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New Military Law Impacts Treatment of Wages and Benefits

President Bush has just signed the Heroes Earnings Assistance and Relief Tax Act of 2008 into law. In addition to providing tax breaks and incentives for military personnel, the law impacts employers' treatment of differential wage payments and their retirement plans. It could also affect their health flexible spending arrangements.

Heroes Earnings Assistance and Relief Tax Act of 2008

The Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART) grants tax and other relief to members of the U.S. armed forces and affects how employers will treat the wages and benefits of employees on military leave. In several instances, the law expands rights granted employees returning from military service under the Uniformed Services Employment and Reemployment Rights Act (USERRA). HEART was signed into law on June 17, 2008.

Pay Differentials Treated as Wages

When employees are on leave from employment for military duty, some employers make up the difference between the military pay and the civilian pay. The IRS position has been that these payments were not wages for income or payroll tax withholding purposes. Thus, these amounts have been reported on Form 1099, and the individual has been responsible for federal income taxes. Further, these individuals have been unable to make elective deferrals to a Section 401(k) plan or other pre-tax contributions from these amounts.

Under HEART, "differential wage payments" made by an employer with respect to any period during which an employee is on active duty for a period of more than 30 days are treated as wages to the employee for purposes of income tax withholding, but not for payroll tax purposes. The law defines a differential wage payment as any amount that represents all or a portion of the wages the employee would have received while working for the employer. This provision is effective only for differential wage payments made after December 31, 2008.

> ***BUCK COMMENT.*** *This change is welcome and may encourage employers to provide differential pay. Many employers wanted to allow employees to continue to contribute to their plans and encouraged Congress to facilitate this.*

HEART also provides a tax incentive for employers with fewer than 50 employees to provide differential wage payments – i.e., a tax credit of 20 percent of the eligible differential wage payments for each qualified employee,

up to a maximum of $4,000 per employee. This provision is effective for amounts paid after the date of enactment and before January 1, 2010.

Differential Wage Payments and Retirement Plans

For retirement plan purposes, HEART provides that individuals receiving differential wage payments are considered employees and the payments are treated as compensation. Thus, employee contributions to retirement plans (e.g., Section 401(k) and Section 403(b) plans) may be made from differential wage payments. These contributions will reduce any contributions an employee may be able to make upon return to employment under USERRA. When contributions or benefits under a retirement plan are based on differential wage payments, all employees of the employer who are serving in the uniformed services (as defined in USERRA) must be entitled to receive differential wage payments on reasonably equivalent terms and, if eligible to participate in the retirement plan, to make contributions based on the payments on reasonably equivalent terms.

These provisions apply to years beginning after December 31, 2008. Plan amendments to comply with these provisions must be made by the end of the last day of the first plan year beginning on or after January 1, 2010 (2012 for governmental plans). A plan will be treated as operating under its terms as long as the plan is amended retroactively and operated in accordance with the amendment from its effective date.

Distributions of Elective Deferrals

Under HEART, an individual on active duty for more than 30 days is considered to have been severed from employment for purposes of taking a distribution of elective deferrals from a Section 401(k) plan, a Section 403(b) plan or a Section 457(b) plan. However, an individual who elects such a distribution is prohibited from making elective deferrals or employee contributions during the six-month period beginning on the date of the distribution. This provision is effective for years beginning after December 31, 2008.

Penalty-Free Withdrawals from Defined Contribution Plans

An individual who takes an early distribution from a qualified retirement plan is generally subject to a 10 percent penalty on the amount of the withdrawal. However, the Pension Protection Act of 2006 temporarily amended the Internal Revenue Code to allow qualified reservists (i.e., those called to active duty for 180 or more days) to receive a distribution from a Section 401(k) plan, a Section 403(b) plan, or other similar arrangement without triggering the 10 percent penalty, and to repay the amount withdrawn to an IRA within two years of the last day of active duty. The new law makes this provision permanent, effective December 31, 2007 (the date on which it expired).

Survivor Benefits Other than Benefit Accruals

HEART imposes a new qualification requirement on qualified retirement plans. To remain qualified, a plan must provide that survivors of a participant who dies while performing qualified military service are entitled to any benefits other than accruals (e.g., accelerated vesting, ancillary life insurance benefits) they would have received had the participant returned to work the day before death and then terminated employment on the day of death. This requirement applies to Section 403(b) plans and Section 457(b) plans as well as to Section 401(a) qualified plans.

Benefit Accruals Upon Death or Disability

USERRA governs employment and benefits for employees returning from military duty and provides that a returning employee's military service is considered employment for benefit accrual purposes. HEART permits (but does not require) a plan to treat an individual who dies or becomes disabled (as defined under the plan) while performing qualified military service as if he or she had resumed employment on the day before his or her death or disability and then terminated employment on the date of death or disability. In essence, this provision allows an employer to treat an employee who dies or becomes disabled in military service as though he or she had worked until death or disability for benefit accrual purposes. If a plan sponsor includes this provision in its plan, all individuals who die or become disabled while performing military service must be credited with service and benefits on reasonably equivalent terms.

USERRA also provides that a returning employee is entitled to accrued benefits that are derived from employee contributions or elective deferrals that the employee makes up upon his or her return from active service. HEART provides that for an employee who dies or becomes disabled in active military service, the amount of contributions and elective deferrals for this purpose is determined based on the individual's average actual contributions or elective deferrals for the 12-month period of service with the employer immediately before the qualified military service, or the actual length of continuous service, if less.

These provisions (including the survivor benefit plan qualification requirement) apply with respect to deaths and disabilities occurring on or after January 1, 2007. Plan amendments must be made by the end of the last day of the first plan year beginning on or after January 1, 2010 (2012 for governmental plans). A plan will be treated as operating under its terms as long as the plan is amended retroactively and operated in accordance with the amendment from its effective date.

> ***BUCK COMMENT**. Due to the retroactive effective date of the survivor benefit plan qualification requirement, plan sponsors should review whether there are any affected survivors for which benefits need to be adjusted.*

Health FSA Contributions

HEART amends IRC Section 125 to allow employers to provide "qualified reservist distributions" from health flexible spending accounts (FSAs) to employees who are called to active duty for 180 or more days or for an indefinite period of time. A qualified reservist distribution is a distribution of all or a portion of the balance in an employee's account that is made during the period that begins on the date of the order or call up and ends on the last date that reimbursement could otherwise be made under the health FSA for the plan year. These distributions may be made after the date of enactment, i.e., June 17, 2008.

> ***BUCK COMMENT.*** *The purpose of this provision is to prevent reservists from forfeiting their health FSA account balances when they are called to active duty during the plan year. There are a number of considerations in implementing this type of provision, such as plan amendments, communications, payment processes and tax reporting. Until more guidance is issued, employers are unlikely to implement this option.*

Mental Health Parity

The Mental Health Parity Act, which prohibits employer-sponsored health plans from imposing annual or lifetime dollar limits on mental health benefits that are not imposed on medical or surgical benefits, expired on December 31, 2007. HEART extends the Mental Health Parity Act for one year, through December 31, 2008.

Conclusion

The new military assistance law includes many provisions that could impact employers' payroll systems or employee benefit plans. Although many provisions may be implemented on a voluntary basis, some are mandatory and will require plan amendments, communications and procedures.

Buck's consultants would be pleased to discuss the new law with you and help you implement its provisions.