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IRS Addresses HEART Changes for Employers

The Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART) provided tax breaks and incentives for military personnel and affected how employers treat the wages and benefits of employees on military leave. In Notice 2010-15, the IRS addresses various HEART provisions, including those affecting differential wage payments, survivor and disability retirement benefits and certain plan distributions.

Background

HEART, signed into law on June 17, 2008, granted tax and other relief to members of the uniformed services and affected how employers treat the wages and benefits of employees on military leave. (See our June 18, 2008 [For Your Information](#).) It expanded certain rights granted under the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA).

The IRS previously issued guidance on qualified reservist distributions from health flexible spending accounts under HEART. (See our October 6, 2008 [For Your Information](#).) Recently, the IRS issued Notice 2010-15, which provides guidance on certain other HEART provisions affecting employers.

Notice 2010-15

[Notice 2010-15](#) provides guidance in question-and-answer format on HEART provisions relating to the treatment of differential military pay as wages, survivor and disability payments for qualified military service, certain retirement plan distributions to individuals called to active duty, and contributions of military death gratuities to Roth IRAs and Coverdell education savings accounts.

Differential Wage Payments. Under HEART, differential wage payments to a participant on qualified military service are considered “wages” subject to federal income tax withholding. Although differential wage payments do not have to be treated as compensation for purposes of determining plan contributions and benefits, the notice clarifies that they must be treated as plan compensation for purposes of applying other provisions of the Internal Revenue Code such as the Section 415(c)(3) definition of compensation. It also clarifies that excluding differential wage payments from a plan’s definition of compensation for purposes of determining contributions and benefits will not result in the definition failing to satisfy the Section 414(s) definition of compensation for nondiscrimination purposes.

The notice indicates that providing contributions or benefits from differential wage payments will not cause a plan to fail any nondiscrimination requirements as long as they are provided on reasonably equivalent terms, and they are not required to be included for testing purposes. However, if such contributions and benefits for any employee are included for testing, they must be taken into account for all employees.

Survivor and Disability Retirement Benefits. HEART requires qualified retirement plans, Section 403(b) plans, and Section 457(b) governmental plans to provide to the survivors of a participant who dies while performing qualified military service any additional benefits (other than benefit accruals for the military service period) the plan would have provided had the participant resumed employment and then died. The notice confirms that additional benefits include accelerated vesting, ancillary life insurance benefits, and other survivor benefits contingent on termination of employment due to death but that these survivor rights apply only when the participant would have been entitled to reemployment under USERRA if he or she were reemployed immediately before death.

Although not required, HEART permits a plan to treat, for benefit accrual purposes, individuals who die or become disabled while performing qualified military service as if they returned to work on the day before their death or disability and terminated the following day. The IRS confirms that if a plan provides benefit accruals for a deceased individual for the period of qualified military service, it must also provide vesting credit for that period. However, a plan that provides benefit accruals for participants who become disabled during qualified military service does not have to provide vesting credit for the period of qualified military service.

For purposes of determining employer contributions contingent on elective deferrals upon reemployment, an individual who dies or becomes disabled while performing qualified military service is deemed to have made employee contributions or elective deferrals. The amount of deemed deferrals or other employee contributions is generally based on the average actual deferrals or contributions made during the lesser of the 12-month period of service with the employer immediately preceding military service or the actual length of continuous service with the employer. The notice provides that if a plan permits actual deferrals for disabled individuals, the employer contributions may be based on an individual's actual deferrals.

Certain Plan Distributions. HEART permits (but does not require) Section 401(k), 403(b) and 457(b) governmental plans to make special distributions of elective deferrals to individuals who are on qualified military service for more than 30 days (i.e., a deemed severance from employment distribution), provided the individuals are not permitted to make elective deferrals and other after-tax contributions for six months following the date of their distributions. The notice clarifies that this option is not limited to employees receiving differential wage payments and does not apply to individuals who have an actual severance from employment or are otherwise eligible to take a distribution.

HEART also made permanent the rules applicable to qualified reservist distributions, which are not subject to the six-month suspension rule or the 10-percent early distribution penalty. A qualified reservist distribution is a distribution made to a reservist called up for military service for more than 179 days during the period beginning

on the date of the call to duty and ending at the close of the active duty period. The notice provides that a distribution that would qualify as both a deemed severance from employment distribution and a qualified reservist distribution will be treated as a qualified reservist distribution. The notice also clarifies that a deemed severance from employment distribution is an eligible rollover distribution.

Military Death Gratuities. Payment of a military death gratuity to an eligible survivor of a service member is excludable from income as are generally life insurance proceeds under the Servicemembers' Group Life Insurance Program (SGLI). The notice confirms that the timely contribution of the gratuity or SGLI proceeds to a Roth IRA or to a Coverdell education savings account is not subject to the annual contribution limits and the phase-out based on income.

Small Employer Tax Credit. For small business employers (i.e., less than 50 employees on average), HEART provides an income tax credit for differential wage payments to employees who are active duty members of the uniformed services, equal to 20 percent of the sum of the eligible differential wage payments made during the tax year to qualified employees. The notice confirms that the maximum amount of eligible wage payments that may be taken into account in the tax year is \$20,000 per qualified employee, for a maximum credit of \$4,000 per qualified employee.

Plan Amendments. The notice clarifies that plans must be amended to comply with HEART requirements by the last day of the first plan year beginning on or after January 1, 2010 (January 1, 2012 for governmental plans).

Conclusion

HEART includes many provisions – some mandatory and some voluntary – that could impact employee benefit plans that cover employees who are on active military duty. The IRS has now provided some clarifications for employers regarding these provisions.

Buck's consultants would be pleased to review the new guidance with you, and assist in your compliance and plan amendment efforts.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.