HEART Act Changes Retirement Plan Rules for Military Reservists

In June, the Heroes Earnings Assistance and Relief Tax ("HEART") Act became law. The Act makes a number of significant changes to the treatment of military reservists under employee benefit plans. This article summarizes those changes as they apply to qualified defined benefit and defined contribution plans, Section 403(b) plans, and Section 457(b) government plans.

In each case, the HEART Act changes are triggered by "qualified military service," as that term is defined in the Uniformed Services Employment and Reemployment Rights Act ("USERRA"), *i.e.* service in the uniformed services, including active duty, active-duty training, and full-time service in the National Guard.

MANDATORY CHANGES

Survivor Benefits. The Act imposes a new requirement that applies when a participant dies while performing qualified military service. In such a case, qualified plans, 403(b) plans, and governmental 457(b) plans must pay any death benefit under the plan as if the participant had *returned* to work and then terminated employment on account of death. Thus, if the plan provides accelerated vesting or ancillary life insurance benefits to participants who die in-service, it must also provide those benefits to participants who die while performing qualified military service.

The Act does not require plans to pay any benefit the participant would have accrued during the period of military service — though (as discussed below) plans may do so voluntarily. This change is effective with respect to deaths occurring on or after January 1, 2007.

Treatment of Differential Pay. Many employers continue paying a portion of a reservist's wages when he or she is called to active duty. The Act does not require employers to offer such "differential pay," but it clarifies the tax treatment of these amounts and imposes a new rule concerning their treatment for benefit accrual purposes.

As defined in the HEART Act, differential pay is any payment an employer makes to an individual who is on active duty for more than 30 days that represents all or part of the wages the individual would have received had he or she continued working for the employer. Under prior law, such pay was not treated as "wages" for purposes of income tax withholding, and it was treated as "compensation" under retirement plans only if the plan so provided. Under the Act, however, differential pay *must* be:

- included as wages (and therefore reported on Form W-2, rather than Form 1099), effective January 1, 2009; and
- treated as "compensation" for purposes of benefit accruals under any plan subject to USERRA beginning, with the 2009 plan year.

Some sponsors may worry that differential pay may cause an inadvertent violation of the Tax Code's nondiscrimination and minimum coverage requirements. The Act addresses these concerns by creating a "safe harbor." Plan contributions and benefit accruals required under the HEART Act's differential pay rules will be exempt from the Tax Code's minimum coverage and

nondiscrimination rules if all the employer's employees are entitled to differential pay on reasonably equivalent terms, and all employees eligible to participate in a retirement plan maintained by the employer are entitled to make contributions based on such differential pay on reasonably equivalent terms.

Deemed Severance from Employment.

The Act's final mandatory rule is intended to facilitate "in-service" distributions from defined contribution plans. Such plans must treat participants receiving differential pay as having severed employment for purposes of distributions of the following amounts:

- 401(k) elective deferrals;
- salary reduction amounts under Section 403(b) plans;
- all contributions to 403(b)(7) custodial accounts; and
- amounts deferred under eligible Section 457(b) plans.

If a reservist receives an "in-service" distribution of such amounts, he or she will not be permitted to make elective deferrals or employee contributions to the plan for the six months following the distribution.

Many commentators have noted the ironic tension between this rule and the previous rule: differential pay recipients must be treated as *employees* with respect to their differential pay, but must be treated as having *terminated employment* for purposes of the new "in-service" distributions.

OPTIONAL CHANGES

The HEART Act includes two entirely optional provisions applicable to retirement plans. Both are related, however, to the mandatory changes discussed above.

Additional Benefit Accruals in the Event of Death or Disability. As explained above, qualified plans, Section 403(b) plans, and governmental Section 457(b) plans must treat participants who die while performing qualified military service as if they had returned to employment and then terminated on account of death. The death benefit required in such circumstances *excludes* benefits that would have accrued during the period of military service.

In a related provision, the HEART Act permits such plans to *include* all or part of the benefit accruals the participant would have earned during the period of military service if he or she is unable to return to work because of death or disability. Thus, such plans may treat a participant who dies or becomes disabled while performing qualified military service as if he or she had "never left."

As applied to defined contributions plans, this rule permits employers to make matching contributions on behalf of a reservist who never makes the deferrals that would ordinarily trigger the match. Any such contributions must, however, be calculated on the basis of the individual's *actual* contributions to the plan during the 12-month period of service immediately preceding the military service (or the actual period of service, if shorter).

These changes may be applied to participants who die or become disabled after January 1, 2007. Any contributions made or accruals earned in this fashion must, however, be made available on a reasonably equivalent basis to all affected participants in the employer's controlled group.

Qualified Reservist Distributions. The Pension Protection Act of 2006 (the "PPA") permitted 401(k) and 403(b) plans to offer qualified reservist distributions ("QRDs") to certain individuals called to active duty. QRDs are exempt from the 10-percent penalty that usually applies to distributions made before the participant has attained age 59½. Reservists may also "repay" QRDs to an IRA, without regard to the usual contribution limit, during the two-year period beginning on the day after their active duty ends.

The PPA provision applied only to reservists activated before December 31, 2007. The HEART Act eliminates this sunset provision, making the QRD option permanent. Under the new rule, QRDs must meet the following requirements:

- The distribution must be attributable to salary deferrals under a 401(k) or 403(b) plan (or an IRA);

- The participant must have been called to active duty after September 11, 2001, for a period of at least 180 days (or an indefinite period); and

- The distribution must be made during the period of active duty.

DIFFERENTIAL PAY TAX CREDIT FOR SMALL BUSINESSES

The Act also offers a significant tax incentive to small employers (those with fewer than 50 employees) who provide differential pay. With respect to differential pay paid after June 17, 2008, and before January 1, 2010, such employers will receive a credit against their federal tax liability equal to 20% of the differential wage payments they make to each qualified employee.

This credit is subject to several conditions, however. For example, it is capped at $20,000 per qualified employee; it is available only if the employer provides eligible differential wage payments to *all* of its qualified employees, under a written plan; it must be "set off" against any other federal tax credit that applies to the same compensation; and it is not deductible.

ACTION ITEMS

Review Procedures for Mandatory Changes. Plan sponsors should review their plans to determine whether the HEART Act requires the payment of survivor benefits that would not otherwise have been due. If you think changes are necessary, please contact your Plan Account Manager. Note that the mandatory survival benefit changes are already effective and apply to deaths occurring as early as *January 1, 2007*.

Sponsors that offer differential pay will also need to adopt new payroll and plan administrative procedures to ensure that such payments are included in both the recipient's wages and his or her retirement plan compensation on and after January 1, 2009. Distribution procedures and forms for defined contribution plans will also require attention to address the new "in-service" distribution rules.

Decisions Regarding Optional Benefits. Once sponsors have addressed mandatory changes, they should consider whether to provide any of the additional benefits authorized by the Act. Sponsors that do not offer QRDs or differential pay might wish to add these features. If you wish to do so, please contact your Plan Account Manager for further instructions.

Plan Amendments. Although some of the HEART Act's mandatory provisions are *effective* immediately, they need not be reflected in plan documents until the end of the 2010 plan year (2012 for governmental plans).

The IRS's position with respect to discretionary amendments to qualified plans is that such changes must be adopted by the end of the plan year in which they become effective. Amendments for the discretionary HEART Act changes may, therefore, be necessary considerably earlier than those required for the mandatory changes.

The IRS has yet to provide guidance with respect to the timing of discretionary amendments to Section 403(b) and Section 457(b) plans. The safest approach to such amendments is, therefore, to adopt the changes before benefits would accrue under the new provisions.

Please contact your Plan Account Manager if you wish to add a discretionary amendment at this time.