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HEART Act Addresses Differential Wage Payments and Retirement and Cafeteria Plan Benefits for Employees Called to Active Duty

The Heroes Earnings Assistance and Relief Tax Act of 2008 (the "HEART" Act), enacted earlier this summer, includes various provisions affecting employers with employees performing qualified military service under the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"). These provisions deal with differential wage payments, retirement plan benefits, and distributions from a cafeteria plan or health flexible spending arrangement ("FSA").

Differential Wage Payments

When an employee is called to active duty in the military (including the National Guard), in some cases, the civilian employer voluntarily pays the employee the difference between the employee's civilian pay and his or her military pay, referred to as "differential wage payments." Under prior IRS guidance, because an employee called to active duty is treated as terminating employment, differential wage payments are not wages for purposes of FICA, FUTA or income tax withholding; however, they may be treated as compensation for retirement plan purposes. Under the HEART Act, effective in 2009 (except as specified below):

- Differential wage payments must be treated as wages for income tax withholding purposes;
- An individual receiving differential wage payments must be treated as an employee, and differential wage payments must be treated as compensation, for retirement plan purposes;
- Notwithstanding the preceding rule, an individual receiving differential wage payments is treated as having severed employment for purposes of receiving distributions from a 401(k), 403(b), or 457(b) plan (subject to a subsequent six-month restriction on deferrals under the applicable plan); and
- A small employer (i.e., an employer with fewer than 50 employees) making differential wage payments may be eligible for an income tax credit of 20% of the first \$20,000 of payments to each employee, effective for payments made after June 17, 2008 and before January 1, 2010.

Death or Disability During Military Service

Under USERRA and the Internal Revenue Code, if an employee returns to employment with a civilian employer after a period of qualified military service and resumes participation in the employer's retirement plan, the employee must be provided retroactively with service credit and contributions or benefit accruals that would have otherwise been provided under the plan during the period of military service. Service credit and contributions or benefit accruals are not required if the employee does not return to employment. Under the HEART Act, effective for deaths and disabilities occurring after 2006:

- If an employee dies or becomes disabled during a period of qualified military service, a retirement plan may provide, in full or in part, the service credit and contributions or benefit accruals that would have applied if the employee had resumed employment before death or disability; and
- If an employee dies during a period of qualified military service, survivor's benefits (other than benefits attributable to contributions or benefit accruals for the period of military service) must be provided as if the employee had resumed employment and then terminated employment on account of death.

Timing of Retirement Plan Amendments

Although operational compliance with the retirement plan changes under the HEART Act is required as of their effective dates, plan amendments to reflect the changes are not required until the end of the 2010 plan year (2012 plan year in the case of governmental plans).

Distributions for Unused Cafeteria Plan or Health FSA Benefits

Under IRS rules, distributions can be made to an employee from an account under a cafeteria plan or health FSA only for the benefits or expense reimbursements specified under the cafeteria plan or health FSA. In addition, the IRS "use it or lose it" rule requires an employee to forfeit any unused balance in a cafeteria plan or health FSA account at the end of the period for which benefits or expense reimbursements can be provided. Under the HEART Act, effective June 17, 2008, if an employee is called to active duty for at least 180 days (or an indefinite period), the unused balance in the employee's cafeteria plan or health FSA account can be distributed to the employee without disqualifying the cafeteria plan or health FSA.

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