

New Heroes Act Improves Pay and Employee Benefits for Military Personnel

Recently, Congress passed the Heroes Earnings Assistance and Relief Tax Act of 2008 (the "Heroes Act"), which changes certain rules pertaining to retirement plans, health flexible spending accounts ("health FSAs"), and group health plans with the goal of increasing or improving the pay and employee benefits provided to employees in military service. President Bush is expected to sign the Heroes Act into law shortly.

Additional Plan Benefits

Under the Heroes Act, if any participant in a qualified retirement plan, 403(b) plan or 457(b) plan dies any time after 2006 while performing military service, the participant's beneficiaries are entitled to any additional benefits (other than those accruing with respect to the period of military service) that would have been provided under the plan had the participant resumed active employment with the employer maintaining the plan and then died. The additional benefits include accelerated vesting, ancillary life insurance, and any survivor benefits which are contingent upon the participant's death while being in active employment.

Further, for purposes of determining a participant's benefit accruals, a qualified retirement plan, 403(b) plan, 457(b) plan, or simplified employee pension plan may (but need not) treat any participant who dies or becomes disabled anytime after 2006 while performing military service as if he or she had resumed active employment on the day preceding death or disability and then died or became disabled the next

day. However, the plan may use this optional rule only if it credits all participants who die or become disabled while performing military service with service and benefits on reasonably equivalent terms. Also, if a plan uses this optional rule, for purposes of determining the amount of the matching contributions to which the participant is entitled, the participant is treated as having made elective contributions and after-tax contributions to the plan at a rate based on the participant's average actual elective contributions and after-tax contributions for the participant's 12-month period of service with the employer immediately prior to the start of the military service (or if less, the average for the actual period of service).

Differential Pay

Under the Heroes Act, any "differential wage payment" made to an employee is treated as compensation of that employee on which contributions or benefits under a qualified retirement plan, a 403(b) plan, a 457(b) plan, or a simplified employee pension plan may be based and on which the employee may base contributions to his or her IRA. A "differential wage payment" is any payment which:

- is made after 2008;
- is made by an employer to an employee with respect to a period, exceeding 30 days, during which the employee is performing military service; and

- represents all or a portion of the wages the employee would have received from the employer if he or she had been in active employment with the employer during such period.

The nondiscrimination, participation, and coverage requirements of the Internal Revenue Code (the "Code") generally do not apply to any contribution or benefit under a qualified retirement plan or 403(b) plan based on differential wage payments, so long as all employees performing military service are entitled to receive differential wage payments, and (if eligible) to participate in a retirement plan of the employer and make contributions under that plan based on the differential wage payments, on reasonably equivalent terms.

A differential wage payment is taxable to the employee. It is treated as wages and is therefore subject to income tax withholding. The differential wage payment rules apply in years starting after 2008.

Plan Distributions of Elective Deferrals and Other Amounts

In plan years starting after 2008, any employee who performs military service for more than 30 days is treated as having incurred a severance from employment and thus may receive a distribution of any amount which is:

- attributable to elective deferrals from a 401(k) plan or a 403(b) tax-sheltered annuity;
- held in a custodial account described in Section 403(b)(7) of the Code; or
- deferred under a 457(b) plan.

However, if the employee receives a distribution under this rule, the employee may not make an elective deferral or other employee contribution to the distributing plan, annuity, or account during the six-month period beginning on the date the distribution is made.

Qualified Reservist Distributions

Prior to the Heroes Act, the Code provided that the 10% penalty on early (i.e., pre-age 59 and 1/2) payments from a qualified retirement plan, 403(b) plan, or an IRA did not apply to any "qualified reservist distribution." Further, any individual who receives a "qualified reserv-

ist distribution" may contribute all or a portion of the distribution to an IRA at any time during the two-year period beginning on the day after his or her military service ends (or beginning on August 17, 2006, if later). For this purpose, a "qualified reservist distribution" is a distribution which is made:

- from a 401(k) plan or 403(b) plan of amounts attributable to elective deferrals, or from an IRA;
- to an individual ordered or called to active military duty after September 11, 2001, and before December 31, 2007, for a period in excess of 179 days or for an indefinite period; and
- during the period which begins on the date of such order or call and which ends at the close of the period of active military duty.

The Heroes Act revises this definition for individuals ordered or called to active military duty on or after December 31, 2007, by eliminating the "and before December 31, 2007" limitation. Thus, for individuals ordered or called to active military duty on or after December 31, 2007, the Heroes Act makes permanent the exemption for qualified reservist distributions from the 10% penalty for early payments.

Distributions from Health Care Flexible Spending Accounts

The Heroes Act permits a "qualified reservist distribution" to be made from an employee's health care flexible spending account. For this purpose, a "qualified reservist distribution" is defined as any distribution to an employee of all or a portion of the balance in the employee's health care flexible spending account when: (1) the employee had been ordered or called to active military duty for a period in excess of 179 days or for an indefinite period; and (2) the distribution is made during the period which begins on the date of such order or call and which ends on the last day of the coverage period of the account that includes the date of such order or call. The purpose of this rule is to allow an individual to withdraw amounts in his or her health care flexible spending account so that the amounts will not be forfeited under the "use-it-or-lose-it-rule." A distribution made under this rule is not taxable. This rule applies to distributions made from health care flexible spending accounts on or after the date of enactment for the Heroes Act.

Mental Parity Act

The Heroes Act amends the Code, the Employee Retirement Income Security Act, and the Public Health Service Act to extend the mental health parity rules for group health plans and the related \$100 per day excise tax penalty for the failure to meet those rules through the end of 2008.

plan, or a simplified employee pension plan, as applicable, need not be amended to reflect the new rules pertaining to mandatory additional benefits, differential pay, and plan distributions until the last day of the first plan year starting after 2009.

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This update was written by Stanley D. Baum (+1 212 698 3838; stanley.baum@dechert.com).

Plan Amendments

A qualified retirement plan (including a 401(k) plan), 403(b) plan (including a 403(b)(7) account), 457(b)

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/employeebenefits.

Robert W. Ballenger
Philadelphia
+1 215 994 2208
robert.ballenger@dechert.com

Wm. Scott Magargee III
Philadelphia
+1 215 994 2609
scott.magargee@dechert.com

Shannon Rushing
Philadelphia
+1 215 994 2949
shannon.rushing@dechert.com

Stanley D. Baum
New York
+1 212 698 3838
stanley.baum@dechert.com

Melissa K. Ostrower
New York
+1 212 698 3624
melissa.ostrower@dechert.com

Stephen W. Skonieczny
New York
+1 212 698 3524
stephen.skonieczny@dechert.com

Susan M. Camillo
Boston
+1 617 728 7125
susan.camillo@dechert.com

Drew A. Picciafoco
Boston
+1 617 728 7109
drew.picciafoco@dechert.com

Frank B. Tripodi
Philadelphia
+1 215 994 2685
frank.tripodi@dechert.com

David F. Jones (Chair)
Philadelphia
+1 215 994 2822
david.jones@dechert.com

Beth L. Rubin
Philadelphia
+1 215 994 2535
beth.rubin@dechert.com

Jessica R. Zaklad
Philadelphia
+1 215 994 2175
jessica.zaklad@dechert.com

Paul S. Kimbol
Philadelphia
+1 215 994 2603
paul.kimbol@dechert.com

Eric B. Rubin
Philadelphia
+1 215 994 2946
eric.rubin@dechert.com

Kathleen Ziga
Philadelphia
+1 215 994 2674
kathleen.ziga@dechert.com