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Re: Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act)

Dear Clients and Other Friends:

The Heroes Earnings Assistance and Relief Act of 2008 (HEART Act) became effective June 17, 2008. It contains a number of provisions designed to increase benefits to military personnel and their families. In addition, there are a few areas where it could potentially cause reduced benefits if employers and employees are not vigilant. Employers need to review their benefit plans to determine which provisions apply to them and which optional provisions they want to implement.

The provisions of the HEART Act that affect benefit plans generally apply to participants in "qualified military service." "Qualified military service" is active military service while the participant is entitled to reemployment rights under the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA).

Generally, plans must be amended by the end of the 2010 plan year.

Retirement Plans

Survivor Benefits: All qualified retirement plans, 403(b) plans and 457 plans must be amended to provide that the survivors of a participant who dies while performing qualified military service are entitled to all benefits under the plan that they would have received if the participant had returned to employment and then died. *This benefit must be provided for any participants who die in qualified military service on or after January 1, 2007*, so plans may need to provide retroactive survivor benefits in some cases.

Benefit Accruals: In addition, a plan may (but does not have to) provide additional benefit accruals to participants who die or become disabled while engaged in active military service. USERRA provides that certain service members who return to work after active duty ends must be credited with the benefit accruals or employer contributions they would have earned if they had remained continuously employed. The HEART Act allows plans to treat participants who die or become disabled while in qualified military service the same way – as if the participant had resumed employment on the day before death or disability and then terminated employment on the date of death or disability. If an employer adopts this provision, it must apply to all individuals in the employer's controlled group on reasonably equivalent terms. If the plan benefit is contingent on employee contributions or elective deferrals, the plan must use the participant's average actual deferrals or contributions for the 12-month period of service immediately before military service, or the actual period of service if less than 12 months, to calculate the benefit. Again, this provision can be applied to deaths and disabilities occurring on or after January 1, 2007.

Differential Wage Payments: The HEART Act requires that any differential wage payments to an employee who is on active military duty for more than 30 days must be treated as compensation under a plan beginning January 1, 2009. Differential wage payments are payments from the employer that represent all or part of the wages the employee would have received if they had been performing services for the employer.¹ Under this provision, a participant in a 401(k) plan can make deferrals from any differential wage payments. These payments will also become subject to federal income tax withholding effective January 1, 2009.²

One problem that may arise for employers with this provision is if the employer sponsors a defined benefit plan that uses a final average pay formula. Counting differential wage payments as compensation for this purpose could reduce the benefits a participant in qualified military service is entitled to if he or she dies or becomes disabled while the differential wage payments are still counted as part of the final average pay. If there is no further guidance from the IRS on this issue, employers may want to consider excluding years that include differential wage payments from the final average pay formula to prevent a reduction in benefits for participants covered by this provision.

Distributions: Also effective January 1, 2009, participants on active military duty for more than 30 days must be permitted to request a distribution of all elective deferrals from a plan as if the participant had separated from employment. The plan must provide that a participant who takes such a distribution may not make elective deferrals or other employee contributions during the six-month period following the date of distribution.

The HEART Act also makes permanent the provision that reservists called to active duty for a period of at least 180 days are not subject to the 10 percent excise tax for withdrawals of elective deferrals. When the participant returns to active employment, he or she may repay all or any part of the distribution within a 2-year period after the end of active duty.

Rollovers

The HEART Act allows an individual who receives a military death benefit gratuity or payments from a Servicemembers' Group Life Insurance policy to roll those amounts over into a Roth IRA without regard to the contribution limits otherwise applicable to Roth IRAs. This provision is effective for deaths occurring on or after October 7, 2001. However, the rollovers must be done within a year of the individual's receipt of the death benefit or, if later, by June 17, 2009.

Cafeteria Plans

Effective June 17, 2008, a health flexible spending account plan under a cafeteria plan may make distributions to reservists called to active duty for at least 180 days beginning on the date of the participant's order or call and ending on the last date that reimbursements can be made for the plan year.

¹ An employer must pay differential wage payments to all employees of the controlled group on a reasonably equivalent basis to be nondiscriminatory under USERRA.

² For this purpose, an individual retirement account ("IRA") must also recognize differential wage payments as compensation..

Mental Health Parity

The HEART Act renews the mental health parity requirements that had previously expired under the Internal Revenue Code and ERISA. If you offer mental health benefits, you cannot subject them to lifetime or annual dollar limits that are not imposed on other medical benefits. These requirements are set to expire again on December 31, 2008.

Expatriate Issues

The HEART Act contains provisions governing distributions from retirement plans for those who become expatriates and take their retirement distributions outside the United States. An IRA (except for SEP or SIMPLE IRAs) is deemed to be distributed on the date before the expatriation date. This also applies to Health Savings Accounts, Coverdell Education Savings accounts, 529 qualified tuition programs and Archer MSAs. For SEPs, SIMPLE IRAs, qualified plans under 401(a), 403(b)s, deferred compensation plans and most government plans, there is a mandatory 30% withholding on distributions, regardless of any treaty provisions or other withholding rules.

In addition, there are provisions that may make it financially burdensome for certain high net-worth individuals to surrender their green card. Although those provisions are outside the scope of this letter, if you have executives from foreign countries who are working in the United States and who wish to return to their country of origin after their assignment or to retire, you should advise them to consult with a tax attorney before surrendering their green card. Similar provisions apply to high net-worth U.S. citizens who wish to retire abroad and renounce their U.S. citizenship.

These new rules apply to individuals becoming expatriates or surrendering their green cards after June 17, 2008.

If you have questions about any of these provisions, or if you wish to amend any of your plans to implement the optional provisions under the HEART Act, please contact us.

Very truly yours,

Sonja Lemmer Martens

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