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## HEART Act—Mandatory and Permissive Amendments to Qualified Retirement Plans and Health Flexible Spending Accounts

Under the Uniformed Services Employment and Reemployment Rights Act of 1994 (“USERRA”), an employee who takes a qualified military leave is generally entitled to be reemployed if he or she returns to employment within a specified time period. In addition to reemployment rights, a returning veteran also is entitled to the restoration of certain retirement benefits that would have accrued had the employee not been absent due to the qualified military service. The protections provided under USERRA do not apply unless the veteran is reemployed by the veteran’s civilian employer, leaving a gap for individuals who could not return to employment after military leave because of a disabling injury or death. Earlier this Summer, President Bush signed the Heroes Earning Assistance and Relief Tax Act of 2008 (“HEART Act”), which addresses some gaps in prior law, and provides additional benefits to the service members and their beneficiaries in the event of debilitating injury or death.

Based on the new legislation, certain benefits and distributions must be available to employees taking military leave of absences. An employer may voluntarily include additional benefits or options under its cafeteria and retirement plans. For your convenience a brief summary of the

mandatory and optional benefits is outlined below.

### Mandatory Provisions

#### Employment Status of Reservists Called to Active Duty (Effective January 1, 2009)

- **Differential Pay.** Any differential pay a company provides to its employees on military leave must be treated as “compensation” with respect to retirement plans for the affected plan year. In addition, differential pay will be considered “wages” for purposes of federal income taxes. Therefore, taxes must be withheld from differential pay and reported on W-2 forms.
- **Retirement Plan Distributions.** For purposes of the limitation on in-service distributions from an employee’s elective deferral account, an employee will be treated as having been severed from employment during any period the individual is on active duty for a period of more than 30 days. Retirement plans subject to the restrictions on in-service withdrawals must allow such individuals to take distributions from the plan as if the employee severed employment. If an individual elects to take a distribution, his or her elective deferrals and employee contributions to the plan must

be suspended for six months following the date of the distribution.

#### **Increased Survivor Benefits.**

**(Effective Retroactively to January 1, 2007)** If a retirement plan participant dies while performing qualifying military service, the retirement plan is required to provide survivor benefits (but not additional service credit) provided under the plan as if the participant had resumed employment and terminated employment on account of death. This applies to tax-qualified plans, as well as code section 403(b) tax-deferred annuity arrangements, code section 457(b) deferred compensation arrangements, and SEP-IRA plans.

#### **PPA Early Withdrawal Penalty Relief Made Permanent. (Effective January 1, 2008)**

The Pension Protection Act of 2006 ("PPA") provided relief for "qualified reservist distributions" from the 10 percent early withdrawal penalty, which applies to certain retirement plan distributions prior to a participant reaching age 59 ½, or death or disability. Qualified reservist distributions are available to employees called into military service for an indefinite period or a period of at least 180 days. Qualified reservist distributions are distributions from the employee's elective deferral account. The PPA relief applied to reservists called to active duty between September 11, 2001, through December 31, 2007. The HEART Act made this PPA provision permanent.

### **Optional Retirement Plan Changes**

#### **Enhanced Survivor Benefits**

- **Additional Benefit Accrual for Pension Plans. (May be applied for a death or disability occurring on or after January 1, 2007, or a later effective date).** If an employee does not return to employment due to death or disability that occurred while on active duty, the employer may elect to treat the employee as reemployed the day before the death or disability occurred. If this option is added to the plan, it must apply to all employees on active duty leave and cannot be selectively applied to each individual on a case-by-case basis. (The purpose of this provision is to allow employers to reinstate pension rights and benefits that would have been reinstated upon reemployment.)
- **Additional Employer Contributions for Individual Account Plans. (May be applied for a death or disability occurring on or after January 1, 2007, or a later effective date).** If an employee does not return to employment due to death or disability that occurred while on active duty, an employer may elect to make employer contributions for the period of time the employee was on military leave. Employer contributions are based on the employee's average rate of contributions to the plan for the 12 months of employment before the employee was called to active duty. If elected, this benefit must also be given to any employee on military

leave who fails to return to work due to death or disability as a result of active duty.

#### **Cafeteria Plan Change**

**Flexible Spending Account Distributions (May be made effective for distributions after June 16, 2008, or a later effective date).** To prevent reservists from falling victim to the cafeteria plan "use-it-or-lose-it" rule, the HEART Act permits an employer to amend the terms of its cafeteria plan to allow employees to receive a "qualified reservist distribution," from their health flexible spending arrangement ("FSA") accounts. Such distributions are available only for employees who are reservists and are called to active duty for an indefinite period or a period of at least 180 days. The qualified reservist distribution from the FSA may be made beginning on the date of the reservist's order to active duty, but no later than the last date on which a reimbursement to participants can be made in the plan year.

#### **Plan Amendments**

**Amendments (By end of the 2010 Plan Year).** Operationally, mandatory changes become effective on the date specified above, and optional changes are effective either on such dates or a later date selected by the plan sponsors. In either case, appropriate plan amendments must be adopted by the last day of the 2010 plan year.

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