

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

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The Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008, bipartisan legislation designed to deliver tax benefits to reservists called to active duty, was signed into law on June 17, 2008. Some of the changes made by the Act are permissive, while others are mandatory. The focus of this article is on the changes the Act makes to the rules that govern Internal Revenue Code (“Code”) Section 125 plans—or cafeteria plans – and health flexible spending accounts “health FSAs”).

Potential Impact on Health FSAs

One of the potential hardships suffered by military personnel upon a call to active duty is the forfeiture of unused health FSA balances since medical expenses incurred during a period of military service are generally covered on base. The Act amends Section 125 of the Code to permit plan sponsors to make a cash distribution of unused health FSA benefits to eligible individuals without adversely affecting (i.e., disqualifying) the cafeteria plan. Under the prior rules, health FSA funds generally could be used only for reimbursement of qualified medical expenses to a participant. At the end of the plan year, any unused health FSA funds had to be forfeited and could not be returned. Under the Act, plan sponsors can amend their health FSA and cafeteria plan documents to make a distribution of unused health FSA funds from the plan to the reservist. These distributions, called “qualified reservist distributions”, are completely voluntary, but plan sponsors must amend their 125 plans in order to allow for such distributions.

In order for a distribution to be a “qualified reservist distribution”, a number of requirements must be satisfied. First, a “qualified reservist distribution” can be made only to a member of a “reserve component” (as defined in section 101 of title 37 of the United States Code), which means a member of the Army National Guard; U.S. Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve; Air National Guard of the United States; or the Reserve Corps of the Public Health Service. Second, the distributions can be made only to a reservist that, by reason of being a member of a reserve component, has been ordered or called into active duty for (i) 180 days or more or (ii) for an indefinite period. Third, the amount of the distribution must be for “all or a portion of the balance in the employee’s account”. Fourth, the distribution must be made within a certain timeframe. The period for making a qualified reservist distribution begins on the date the reservist is called or ordered to duty and ends on the last day that reimbursements could otherwise be made for the plan year that includes the first day of the distribution period. These requirements raise several issues, each discussed below.

The requirement that is likely to cause the most confusion for Health FSAs is the determination of the amount subject to the special distribution rule. The rule itself is referred to as a “special rule for unused benefits”, while the definition for qualified reservist distribution uses the phrase “all or a portion of the *balance in the employee’s account*”. Does “all or a portion of the balance in the employee’s account” refer to the amount the reservist has actually contributed to his or her health FSA through payroll deduction, or does it refer to the entire health FSA benefit available to the reservist?

Under the uniform coverage rules for health FSAs, the entire amount of the employee's annual election must be available on the first day of the plan year, regardless of how much the employee has actually contributed to the health FSA. As a general rule, plan sponsors do not maintain an actual "account" with a "balance", but merely a notional account. So, for example, assume a reservist elects \$2400 in health FSA benefits and contributes at a rate of \$200 per month. The reservist is called to report for duty on February 1, after having contributed only \$200 to his or her health FSA and seeking reimbursement for \$50 in qualified medical expenses. Does "all or a portion of the balance in the employee's account" mean that the reservist is entitled to \$150, which is how much the reservist actually contributed minus the reimbursement for the qualified medical expense? Or is the reservist entitled to \$2350, which is his or her entire "unused benefit" minus the reimbursement? The phrase "unused benefits" seems broad enough to include the total amount of the entire annual election. On the other hand, the term "balance in the employee's account" could imply that the amount is based on actual payroll deductions, minus any year-to-date reimbursements. Moreover, since adoption of the amendment is optional in the first place, it would seem that plan sponsors should be able to use either interpretation – and we believe most will choose to allow distribution of only the excess portion of contributions over benefits paid. Because plan sponsors will likely be eager to adopt this amendment to provide for qualified reservist distributions, quick formal guidance from the IRS in this area is sorely needed.

Another question is the taxability of the distributed health FSA funds and any applicable reporting and withholding requirements. Because the reservist contributes to his or her health FSA through a cafeteria plan using pre-tax dollars, neither the reservist nor his or her employer has paid any income or employment (FICA and FUTA) on the funds. Presumably, if the reservist receives the cash rather than the nontaxable health FSA benefit, then the qualified reservist distribution should be taxable. Furthermore, the Act provides no exclusion from income for a qualified reservist distribution. Neither the Act nor the Technical Explanation issued by the Joint Committee on Taxation ("JCT") addresses the reporting of the distribution, so it is not clear as to whether a qualified reservist distribution should be reported on a Form W-2. In going along with the presumption that the distribution is taxable, and the presumption that payments while a reservist are compensation for withholding purposes (see discussion below), inclusion of such amounts on Form W-2 would seem to be the most likely treatment—but again, guidance and clarification is needed.

Although the timeframe for making a qualified reservist distribution is relatively clear in the Act, the Joint Committee on Taxation's Technical Explanation may cause some confusion. In the Technical Explanation, the JCT states that the distribution period ends "on the last day of the coverage period of the FSA that includes the date of the call to active duty." This, however, does not seem to be consistent with what the Act says. The Act states that the period for making a qualified reservist distribution begins on the date the reservist is called or ordered to duty and ends on the *last day that reimbursements could otherwise be made for the plan year* that includes the first day of the distribution period. So, for example, if a reservist participating in a calendar year health FSA (that has no grace period) is called to duty on December 31, 2008, the reservist could receive a qualified distribution any time between December 31, 2008 and the last day of the run-out period for the 2008 plan year, most likely March 31, 2009. Under a literal application of the JCT's explanation, the reservist would have to receive his or her distribution on that same day—December 31, 2008—in order for it to be a qualified reservist distribution. By comparison, a reservist in the same plan that is called to duty the next day—January 1, 2009—would have an entire year to receive a qualified reservist distribution (assuming there would be any funds to distribute). By comparison, under a more liberal interpretation of the Act's provision, the reservist could receive a distribution anytime between January 1, 2009 and March 31, 2010.

Another issue raised by the timing requirement is whether a reservist can be eligible for a qualified reservist distribution for two different plan years. For example, assume a reservist is called for active duty on March 1, 2009, and the reservist has unused funds on his or her health FSA from 2008 that will be forfeited at the end of the run-out period (assume March 31, 2009). Also assume the reservist has not yet used his or her 2009 health FSA funds. Can the reservist request a qualified reservist distribution for both the unused 2008 health FSA funds and the unused 2009 health FSA funds? It seems that the answer is no—only the unused 2009 funds are distributable under the Act, even if the plan has adopted the optional 2 ½ month cafeteria plan grace period. This is because the rules limit the distribution to funds attributable to the plan year that includes the date the reservist was called to duty. Accordingly, the qualified reservist distribution is tied to the plan year that includes the date that the reservist was called to active duty.

An additional issue that may arise is whether a reservist has to be a participant in the health FSA on the day he or she is called to active duty in order to be eligible for the qualified reservist distribution. The Act refers only to “individuals” and not to participants. Assume, for example, that a reservist is a participant in a health FSA that allows terminated employees to have until the end of the run-out period for the plan year to submit reimbursement requests. Assume the reservist quits in October, having incurred eligible medical expenses to use up only half of his or her health FSA benefits. Under the plan, he or she has until March 31 of the following year to submit reimbursement requests; however, only expenses that were incurred while a participant in the health FSA are eligible for reimbursement. If the reservist is called to active duty on November 1, would he or she have to forfeit the remaining health FSA benefits, or is he or she eligible for the qualified reservist distribution? The Act does not address this, but presumably plan sponsors can draft their plan amendments to achieve the desired result.

Although the Act states that qualified reservist distributions will not disqualify a cafeteria plan, the Act does not provide any safe harbor for plan sponsors with regard to ensuring that a distribution satisfies all the requirements of a qualified reservist distribution. Because making distributions that are not provided for in the Code and applicable regulations can disqualify a cafeteria plan, plan sponsors may be hesitant to make such distributions until further guidance and clarification is provided regarding the requirements. For example, what if the plan sponsor bases the amount of the qualified reservist distribution on the reservist’s actual contributions rather than on the total annual benefit? Because the basis for the amount of the distribution itself is not entirely clear, a plan sponsor arguably cannot, pending further IRS clarification, be sure that any distribution in any amount is a “qualified reservist distribution.”

As noted above, qualified reservists distributions are completely voluntary, and plan sponsors can only make a qualified reservist distribution after amending their plan to provide for such a distribution. The provision affecting 125 plans takes effect immediately, so plan sponsors may begin amending plans right away. However, given the many unclear issues discussed above, plan sponsors may wish to await further IRS guidance.

Potential Impact of Act on Ability to “Salary Reduce” Differential Pay

Another issue that is likely to concern all cafeteria plan sponsors (whether they sponsor a health FSA or not) is the mandatory requirement to treat differential pay as wages for certain withholding and retirement plan purposes. Some plan sponsors may wonder if differential pay may also be treated as compensation for 125 “salary reduction” purposes as well. Such treatment is not literally addressed by the Act. Even though differential pay must be treated as wages, the Act makes this change only with regard to the definition of “wages” for withholding and

retirement plan purposes. Nonetheless, even without specific guidance under the Act, by analogy, many plan sponsors will likely take the requirement to treat such pay as wages for “withholding” purposes generally to be broad enough to allow pre-tax salary reduction under a cafeteria plan.

Extension of Expiring Mental Health parity Act Provisions Through 2008

The Act extends through 2008 the Code, ERISA, and Public Health Service Act mental parity provisions.

Additional Non-Health Benefit Implications of Act

In addition to the changes made to the health FSA and 125 plan rules, the Act also makes other changes—some of them mandatory—that affect employee benefit plans. Some of these changes include:

- Requiring that survivors of individuals who die during qualified military service receive the same additional benefits (other than accruals) that would be received if the individual died while employed. This applies, for example, if otherwise nonvested benefits vest upon death. This is effective with respect to deaths occurring on or after January 1, 2007, with a delayed date for plan amendments.
- Requiring differential pay to be treated as compensation for retirement plan purposes and requiring individuals receiving differential pay to be treated as an employee for retirement plan purposes. This is effective for years beginning after December 31, 2008, with a delayed date for plan amendments.
- In the case of death or disability during qualified military service, permitting plans to provide accruals on the same basis as if the individual had returned to employment and then died or become disabled. This provision is effective for death or disability occurring on or after January 1, 2007.
- Requiring that differential pay be treated as wages for income tax reporting and withholding purposes, effective for payments after December 31, 2008. The FICA and FUTA provisions are not changed, so the differential pay continues to be exempt for FICA and FUTA purposes.
- Extending permanently the exception to the 10% early withdrawal tax for qualified reservist distributions.
- Providing a credit to small businesses (generally, businesses with fewer than 50 employees) for a portion of differential pay, effective for amounts paid after June 17, 2008, and before January 1, 2010.