

Overview of tax changes in the Heroes Earnings Assistance and Relief Tax Act of 2008

Dear Client,

The recently enacted "Heroes Earnings Assistance and Relief Tax Act of 2008" (the 2008 Heroes Act) provides targeted tax relief for military members and their families, fully offset with tightened expatriation rules, a new rule requiring U.S. companies working under federal government contract to treat overseas employees as subject to employment taxes, and a higher failure to file penalty. Here's a summary of the tax provisions in the Act:

New relief provisions.

The 2008 Heroes Act makes the following liberalizations for members of the military and their families:

- Clarifies that those in the active military who file a joint tax return are eligible for the stimulus rebate payment under the Economic Stimulus Act of 2008 even if one spouse does not have a Social Security number.
- Makes permanent the ability to include combat pay as earned income for purposes of the earned income tax credit (EITC) (under pre-2008 Heroes Act law, this benefit was only available for tax years ending before 2008).
- Makes permanent an exception that permits qualified mortgage bonds to be issued to finance mortgages for qualified veterans who served in the active military without regard to the first-time homebuyer requirement (under pre-2008 Heroes Act law, this exception only applied for bonds issued before 2008).
- Modifies the law which provides certain retirement plan protections for reservists who are called to active duty and who are able to return to their civilian employers after serving our country. The new law requires tax-qualified retirement plans to provide that if a participant dies while performing qualified military service, his or her survivors would be entitled to any additional benefits (other than benefit accruals relating to the period of qualified military service) that would have been provided had the participant resumed employment and then terminated employment on account of death. Similar rules apply to 403(b) annuities and 457(b) plans. Additionally, the new law provides that retirement plans can permit individuals who leave for qualified military service and cannot be reemployed on account of death or disability to be treated as if they had been rehired as of the day before death or disability and then had terminated employment on the date of death or disability. These changes apply to deaths or disabilities occurring after 2006.
- Includes differential wages paid by an employer to an employee who becomes active duty military in the calculation of wages for retirement plan and IRA purposes, effective for years beginning after 2008. Differential pay is also made subject to federal income tax withholding, effective for amounts paid after 2008.
- Extends the limitations period for filing tax refund credit claims arising from Department of Veterans Affairs disability determinations.
- Makes permanent the expiring Internal Revenue Code provision that permits active duty reservists to make penalty-free withdrawals from retirement plans.
- Permits a military death gratuity or amount received under the Servicemembers' Group Life Insurance (SGLI) program to be rolled over to a Roth IRA or Coverdell education savings account, notwithstanding the contribution limits that otherwise apply.

- Entitles Peace Corps volunteers and certain employees to a similar tolling of the homesale exclusion ownership and use period that already applies to members of the uniformed services, Foreign Service, and intelligence community. The Act also makes permanent the special homesale exclusion rules for certain employees of the intelligence community and repeals the requirement that those employees move overseas in order to qualify for special treatment.
- Provides small employers with a 20% tax credit for differential wage payments made to employees who are on active military duty.
- Provides an exclusion for state or local payments of bonuses to active or former military personnel or their dependents on account of such military personnel's service in a combat zone.
- Allows members of the reserves who are called to active duty to withdraw unused amounts held in a health flexible spending account (health FSA).
- Retroactively clarifies that certain property tax rebates and other benefits made with respect to volunteer firefighters, and excluded from gross income under the Mortgage Forgiveness Debt Relief Act of 2007, are not subject to Social Security tax or unemployment tax.

Revenue raising provisions.

To offset the cost of the new tax breaks (and the cost of various SSI liberalizations for the military), the Act:

Tightens the expatriation rules. U.S. citizens and long-term U.S. residents are subject to tax on their worldwide income. Taxpayers can avoid taxes by renouncing their U.S. citizenship or terminating their residence. The Act tightens the expatriation rules to ensure that certain high net-worth taxpayers can't renounce their U.S. citizenship or terminate their U.S. residency in order to avoid U.S. taxes. Under this provision, high net-worth individuals are treated as if they sold all of their property for its fair market value on the day before they expatriate or terminate their residency. Gain is recognized to the extent that the aggregate gain recognized exceeds \$600,000 (which will be adjusted for cost of living in the future). The provision, which applies for those who relinquish U.S. citizenship or terminate their U.S. residency on or after the enactment date, is estimated to raise \$411 million over 10 years.

Treats foreign subsidiaries of U.S. companies performing services under a U.S. government contract as American employers for employment tax purposes. Under the new law, the domestic parent is jointly liable for employment taxes imposed on the foreign subsidiary. The new provision applies to services performed in calendar months beginning more than 30 days after the enactment date and is estimated to raise \$846 million over ten years.

Increases the minimum penalty for a failure to file an individual tax return within 60 days of the due date to the lesser of \$135 (up from \$100) or 100 percent of the amount of tax required to be shown on the return, effective for tax returns required to be filed after 2008. The provision is estimated to raise \$296 million over ten years.

Please keep in mind that this is only a summary of the tax changes in the new law. If you would like to discuss any of these provisions in greater detail, please do not hesitate to call.