



SPECIAL Alert

In This Issue

In this ninth McGraw Wentworth Special Alert for 2008, we discuss Qualified Reservist Distributions (QRDs) which were part of the HEART Act passed earlier this year. QRDs are distributions from health Flexible Spending Accounts (FSAs) that are permitted if an employee is called to active duty for at least 180 days. It is the only time funds can be distributed from an FSA for a purpose other than a qualifying medical expense.

The law allows QRDs but employers are not required to amend their plans to allow them. If employers want to allow them, they need to follow the steps outlined in this Special Alert. The distribution is considered taxable income to the employee.

We welcome your comments and suggestions regarding this issue of our Special Alert. For more information on this article, please contact your Account Manager or visit the McGraw Wentworth web site at www.mcgrawwentworth.com.

“HEART Act: Qualified Reservist Distribution”

President Bush signed the Heroes Earnings Assistance and Relief Act (HEART Act) into law on June 17, 2008. Much of the HEART Act deals with retirement plans but one provision applies to Section 125 plans. The HEART Act allows employers to amend their Section 125 plans so that employees called to active duty in the military can withdraw funds from their health FSAs.

This withdrawal is called a Qualified Reservist Distribution (QRD). Although employers are not required to offer these QRDs, they may do so if they wish.

Just recently, the IRS released Notice 2008-82 to discuss the mechanics of QRDs and employer requirements. This Special Alert reviews the following:

- Definition of QRD
- Plan Amendment Requirement and Transition Rule
- Processing a QRD
- Determining the Amount of QRD

It is important to understand the mechanics to make sure your organization properly administers a QRD.

Definition of QRD

Qualified Reservist Distributions are funds withdrawn from a health FSA. These distributions are allowed only when employees meet the following conditions:

1. The employee is a member of a military reserve program and is called to active duty for at least 180 days.
2. The employee requests the distribution during the period beginning with the call to active duty and ending on the last day of the plan year (or the last day of the grace period, if applicable).

A QRD is an exception to the rule that health FSA funds can only be withdrawn to reimburse substantiated medical expenses. For a QRD to be valid, the employer must follow all the rules outlined in the guidance and summarized in this Alert.



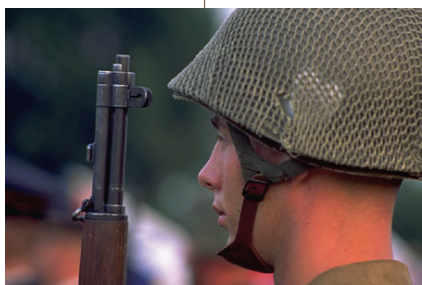
Plan Amendment Requirement and Transition Rule

Before processing a QRD, employers must amend their Section 125 plans to assure the IRS they are allowing QRDs uniformly for all their health FSA participants.

An IRS transition rule applies to QRDs made before January 1, 2010. The transition rule allows a plan to be amended retroactively to permit QRDs requested on or before December 31, 2009. The amendment will be retroactive to the date of the first requested QRD, if that date is after June 18, 2008. Employees must meet all the requirements for requesting a QRD.

This retroactive date does not extend the timeframe in which a QRD must be requested. Under no circumstances can a QRD be requested after the end of the plan year or grace period, for the year in which the call to active duty occurred.

The plan may specify the process an employee must follow to request a QRD. The employer may also limit the number of QRDs an employee can request during the same plan year. The plan must allow an employee to submit health FSA claims for medical expenses incurred before the date a QRD is requested and the plan must reimburse the employee for any substantiated claims.



If a medical expense arises after the date a QRD is requested, the plan may either:

1. Permit the employee to continue to submit health FSA claims incurred before the end of the plan year, or grace period if it applies.
2. Terminate an employee's right to submit claims.

These QRD specifics should be included in the plan amendment.

Processing a QRD

Because only certain employees can request a QRD, employers must verify eligibility using the following guidelines:

- Only an employee called to active duty is eligible. The QRD does not apply if the spouse or a dependent is called to active duty.
- A qualified reservist means a reservist in the Army National Guard, the Army Reserve, the Navy Reserve, the Marine Corps Reserve, the Air National Guard, the Air Force Reserve, the Coast Guard Reserve or the Reserve Corps of the Public Health Services.

- The employer must obtain a copy of the call to active duty before making a QRD. The employer needs this information to verify the length of time the employee will serve.

If the employee was ordered to serve for at least 180 days but does not serve the entire time, the employee can still receive the QRD. If the employee was ordered to serve less than 180 days, the employee cannot receive a QRD. However, if subsequently the total period of active duty increases to more than 180 days, a QRD is then permitted. For example, an employee may be initially called to duty for only 120 days. If those orders are subsequently extended an additional 90 days, at this point, the active duty will exceed the 180 day requirement and the employee may request a QRD.

A QRD request cannot apply to any of the following funds:

- Any account funds forfeited on or before June 18, 2008.
- Any account funds attributable to a prior plan year (including a plan year ending on or before June 18, 2008).
- Any account funds attributable to a non-health FSA.

The regulations clearly state that employers must verify an employee meets the requirements before they permit a QRD.

Determining the Amount of QRD

Employers need to determine how to calculate the employee's FSA balance. The rules also require the employer to describe that process in the plan amendment.

The IRS allows employers to calculate the figures in a few different ways:

1. The entire health FSA amount for the plan year, minus health FSA reimbursements made as of the date of the QRD request.
2. The health FSA amount contributed as of the date of the QRD request, minus any health FSA reimbursements made as of that date.
3. Some other amount (not exceeding the entire amount elected for that health plan year minus any health FSA reimbursements to date).

If an employer does not specify how the plan will calculate the amount of a QRD, the second method above should be used as the default calculation approach.

A few other QRD pointers are as follows:

- The employer must pay the QRD no more than 60 days after the employee requests it.
- A QRD can be made only for an account balance existing on or after June 18, 2008.

- QRD amounts are not considered in Section 125 non-discrimination testing.

An employee can request a QRD to avoid the "use it or lose it" rule under Section 125, but the funds are not tax-free. The funds withdrawn from the account must be included in the employee's gross income and reported on the employee's W-2. The QRD amount may be reduced by any amount in the health FSA attributable to after-tax contributions, for example, contributions made while on COBRA.

Concluding Thoughts

A QRD can be very helpful for employee reservists called to active duty and their families. It makes sense; employees elect the health



FSA based on their planned medical expenses for the year. If they are then called to active duty for six months or more, they may not have the chance to

use those funds for qualified medical expenses during the year. QRDs give these employees an opportunity to ask for a taxable distribution from the health FSA to avoid losing funds they cannot use because they are serving our country.

Employers are not required to offer QRDs under their Section 125 plans, but if they choose to do so, they must amend their plan documents to include the process for requesting a QRD.

If you have any questions regarding QRDs, please contact your McGraw Wentworth Account Manager. [MW](#)

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