2003 Legislative and Regulatory Year in Review and the Outlook for 2004

January 2004

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Highlights of 2003 Federal Legislation and Regulations

In 2003, Republicans officially took control of both the House and Senate, but with narrow margins, especially in the Senate. President Bush's top domestic agenda items included tax cuts to stimulate the economy and Medicare reform including prescription drug coverage. Although the White House and Congress got off to a quick start, the war in Iraq consumed a great deal of attention and resources.

On the human resources legislative front, the Bush Administration scored a major victory in enacting a Medicare reform bill that includes prescription drug coverage for all Medicare beneficiaries beginning in 2006. On the other hand, Congress failed to reach a final agreement on legislation to temporarily replace the 30-year Treasury rate, the extension of many expiring tax provisions, and the fiscal year 2004 appropriations bill that includes cash balance pension plan provisions. Congress has agreed to address these issues when they return in January, and all of these issues are described in more detail in the outlook section.

2003 Enacted Legislation

Medicare Reform and Prescription Drugs

On December 8, 2003, President Bush signed into law the Medicare Prescription Drug, Improvement, and Modernization Act (Public Law 108-173), which represents the largest expansion of the Medicare program since its enactment in 1965. Among its key features, the law adds a temporary prescription drug discount program in 2004 and in 2005, and it adds prescription drug coverage for post-65 and disabled Medicare beneficiaries beginning in 2006 under a new Part D. It also implements a new reimbursement structure for Medicare+Choice plans (now renamed Medicare Advantage) and expands the types of plans available, revises payments to providers, expands Medicare coverage of preventive benefits, and establishes new Health Savings Accounts for individuals who are not Medicare eligible.

For employers providing retiree health coverage that is at least actuarially equivalent to the standard Medicare drug benefit, the law provides that Medicare will pay an amount equal to 28 percent of gross covered prescription drug costs (net of rebates and discounts) between $250 and $5,000 per retiree. This Medicare payment will be excludable from an employer's taxable income, and employers subject to federal income taxes will still be able to deduct the full drug expense even though they receive the 28 percent subsidy from Medicare for the same costs. Together, the direct subsidies and the tax benefits have been estimated to total $89 billion over ten years. Employers also have many other options for coordinating with the Medicare benefit, such as supplementing the Medicare benefit or subsidizing retiree premiums for the Medicare benefit.

The new Medicare law made some changes intended to facilitate the entry of generic drugs into the market. The new law also allows the importation of prescription drugs into the U.S. from Canada, if the Secretary of Health and Human Services (HHS) certifies that commercial importation of such drugs poses no additional risk to the public's health and safety. However, HHS Secretary Thompson has stated that he could not certify the safety of the imported drugs.

Tax Legislation

On May 28, 2003, President Bush enacted the "Jobs and Growth Tax Relief Reconciliation Act" (Public Law 108-27). Among other provisions, the measure cut tax rates as of January 1, 2003 and provided "marriage tax" relief for 2003 and 2004. It also increased the child tax credit to $1,000 for 2003 and 2004, and provided for an advance rebate of up to $400 per eligible child in July 2003. The law also reduced capital gains tax rates and provided that dividends received by individual shareholders from domestic and qualified foreign corporations will be taxed at lower capital gains rates.

Mental Health Parity

On December 19, 2003, President Bush enacted a one-year extension of the current Mental Health Parity Act through December 31, 2004 (Public Law 108-197). The legislation amends ERISA and the Public Health Service Act but not the Internal Revenue Code. Sponsors of legislation to expand the mental health parity law agreed to defer any action in 2003 after committee leaders promised to address the bill in 2004.

Unemployment Compensation

On January 8, 2003, President Bush enacted Public Law 108-1 to provide for a five-month extension of the temporary extended unemployment compensation program until June 1, 2003, and to provide a transition period for individuals receiving compensation when the program ends.

On May 28, 2003, President Bush enacted Public Law 108-26, further extending the temporary extended unemployment compensation until December 31, 2003.

Regulatory Guidance—Benefits in General

Adoption Benefits

The IRS issued Notice 2003-15 on February 10, 2003, to establish certain safe harbors for determining when an adoption of a foreign-born child is considered "final" for purposes of the adoption tax credit and for Code Section 137 employer-sponsored adoption assistance plans. The notice provides a proposed revenue procedure that sets out various rules for determining when the adoption is considered final for tax purposes, depending on whether the child receives an IR-2, IR-3, or IR-4 visa. The rules are effective for expenses incurred or paid after publication of the final revenue procedure. However, the IRS will not challenge the finality of adoptions by taxpayers that apply the revenue procedure in any taxable year for which the limitation period under Section 6511 (regarding credits or refunds from prior taxable years) has not expired.

Regulatory Guidance—Retirement Plans

Retirement Plans in General

Rollover of Retirement Plan Distributions

The IRS released Revenue Procedure 2003-16 on January 8, 2003, regarding the procedure for an individual to apply to the IRS for a waiver of the 60-day rollover requirement for an "eligible rollover distribution" from a qualified retirement plan. The revenue procedure provides an automatic waiver of the 60-day requirement if an individual taxpayer has correctly followed all procedures for the 60-day rollover, but the funds are not deposited because of an error by the financial institution, and certain other requirements are met. The IRS will waive the 60-day requirement in cases such as casualty, disaster, or other circumstances beyond the taxpayer's control.

Employee Plans Compliance Resolution System

The IRS released Revenue Procedure 2003-44 on June 5, 2003, to update and streamline its voluntary Employee Plans Compliance Resolution System (EPCRS) for sponsors of qualified retirement plans. The revenue procedure is generally effective October 1, 2003.

Defined Contribution Plans

Optional Forms of Distribution Under Defined Contribution Plans

On December 17, 2003, the IRS issued final regulations on the required notices for qualified joint and survivor annuities (QJSAs) and qualified preretirement survivor annuities (QPSAs). The final regulations consolidate the content requirements applicable to explanations of QJSAs and QPSAs and also specify disclosure requirements for the relative value of optional forms of benefit. The regulations became effective immediately and apply to QJSA notices for distributions with annuity starting dates on or after October 1, 2004 and QPSA notices provided on or after July 1, 2004. In the case of retroactive annuity starting dates, the date of commencement of the actual payments based on the retroactive annuity starting date is substituted for the annuity starting date.

Participant-Directed Individual Account Plans

The Department of Labor (DOL) issued Advisory Opinion 2003-11A on September 8, 2003, approving the use of "profile" prospectuses by fiduciaries of participant-directed individual account plans under ERISA Section 404(c). However, the opinion makes clear that, while participants may be provided a profile prospectus in lieu of a regular prospectus, investors continue to have the right to request the more detailed traditional prospectus. The rules governing the format and content of profile prospectuses are set out by the SEC. In general, a profile prospectus is intended to provide investors with clear and concise information about mutual funds in a format that avoids the technical and legal terms generally associated with the traditional prospectus.

401(k) Plans

On July 16, 2003, the IRS issued proposed regulations governing 401(k) plans to consolidate and clarify the existing rules. The proposed rules incorporate statutory changes that have occurred since the current regulations were last updated in 1994. Most significantly, the new regulations would make changes to the methodology for testing the amount of elective contributions, matching contributions, and employee contributions for nondiscrimination. For calendar-year plans, the regulations are not likely to be effective before 2006.

Catch-up Contributions
On July 8, 2003, the IRS published final regulations on catch-up contributions for individuals age 50 and older under 401(k) plans, 403(b) tax-sheltered annuities, SIMPLE IRAs, simplified employee pension plans, and certain Code Section 457 governmental plans. The final regulations generally adopt proposed regulations published by the IRS in October 2001, with certain modifications relating to the method for determining catch-up contributions, the universal availability requirement, and other issues. For example, the final regulations ease employer compliance with the universal availability requirement with respect to collectively bargained employees. The universal availability rule requires plans to allow all participants who are eligible to make catch-up contributions to make the same election with respect to additional elective deferrals. The final regulations provide that collectively bargained employees are disregarded for purposes of determining whether a plan complies with the universal availability requirement. The final regulations apply to contributions made in taxable years beginning on or after January 1, 2004.

Plan Expenses in Defined Contribution Plans
The Department of Labor (DOL) issued Field Assistance Bulletin 2003-3 (FAB) on May 19, 2003, which makes significant changes to the DOL position on the allocation of administrative expenses to participants in a defined contribution plan. The FAB states that ERISA generally provides plan sponsors and fiduciaries with considerable discretion in the allocation of plan expenses, provided the expenses are reasonable and proper and there exists a rational basis for the allocation method. The FAB summarizes principles for making decisions about whether plan expenses should be allocated among participants on a pro rata basis versus a per capita basis. The FAB also states that plan sponsors and fiduciaries should have latitude in determining whether a particular expense is allocated to an individual participant versus the plan as a whole, as long as the same principles are followed in making the allocation.

Plan Loans
On April 15, 2003, the Department of Labor (DOL) issued Field Assistance Bulletin 2003-1 (FAB), regarding plan loans (e.g., 401(k) plan loans) to directors and officers of public companies in relation to the SOA. The FAB provides that a plan will not violate ERISA if the plan administrator prohibits plan loans to directors and executive officers. There has been a question of whether plan loans are subject to the SOA rule prohibiting public companies from directly or indirectly making, or arranging for, personal loans to directors and executive officers. So, some plans have prohibited plan loans to directors and officers, but have been concerned this prohibition violates the ERISA requirement that plan loans be made available to all participants on a reasonably equivalent basis. The FAB does not address whether the SOA applies to plan loans, because the authority on this issue falls with the SEC. As a result, the FAB does not require plan sponsors to prohibit plan loans to directors and executive officers.

Blackout Periods

On January 28, 2003, the Securities and Exchange Commission (SEC) published final rules on the prohibition against certain equity transactions by directors and executive officers during a blackout period. The trading prohibitions are triggered by a "blackout period" that lasts more than three consecutive business days, and temporarily suspends the ability of at least 50 percent of the participants or beneficiaries under all individual account plans maintained by the company from making certain transactions relating to employer securities in the individual's account. The final regulations provide additional guidance on issues such as the definitions of issuers and persons subject to the trading limits, as well as the types of securities subject to the limits. The regulations also address exceptions to the definition of blackout period, as well as the required notices to directors and executive officers of an upcoming blackout period. The final regulations generally apply to blackout periods beginning on or after January 26, 2003. There is a delayed effective date for certain required notices to the SEC.

The Department of Labor (DOL) published final regulations on January 24, 2003 regarding the new requirement for individual account retirement plans to provide participants and beneficiaries at least 30 days' notice of an upcoming blackout period. This requirement was part of the Sarbanes-Oxley Act (SOA). The final regulations make a number of technical changes intended to help simplify compliance and contain a revised model notice. The final regulations became effective for blackout periods that began on or after January 26, 2003. On the same day, the DOL published final regulations regarding civil penalties for failure to comply with the new blackout rules, which are effective January 26, 2003.

IRAs Offered Under Qualified Retirement Plans

On May 20, 2003, the IRS published proposed regulations on deemed IRAs that state that the qualified employer plan and the deemed IRA are generally to be treated as separate entities, each subject to the rules applicable to that type of plan. Issues regarding eligibility, participation, disclosure, nondiscrimination, contributions, distributions, investments, and plan administration are generally to be resolved under separate rules. However, the proposed rules provide three specific exceptions: 1) the qualified plan document must contain the deemed IRA provisions; 2) the assets of the deemed IRA may be commingled for investment purposes with the assets of the other portion of the plan; and 3) the failure of the deemed IRA to satisfy the requirements of Section 408 or 408A could cause the plan as a whole to be disqualified. The regulations are proposed to apply beginning on or after August 1, 2003 and may be relied on pending the issuance of final regulations.

On January 2, 2003, the IRS released Revenue Procedure 2003-13, providing guidance and a model amendment for employers that want to amend their qualified retirement plans to include "deemed IRAs" as added by the Economic Growth and Tax Relief Reconciliation Act (EGTRRA). Under the deemed IRA provision, for plan years beginning in 2003 and after, an employer can elect to allow employees to make voluntary contributions to a separate account or annuity established under their qualified plan that meets the Code requirements for a traditional or Roth IRA. The separate account (or annuity) would be treated under the Code as an IRA, not as a qualified employer plan, and contributions would be treated as contributions to an IRA, not the qualified plan. For plan years beginning in 2004, the deemed IRA provisions must be in the plan before any deemed IRA contributions are accepted.

On January 24, 2003, the Department of Labor (DOL) issued Advisory Opinion 2003-01A regarding the applicability of ERISA Title I to a governmental 401(k) plan that added a deemed IRA to its plan. The DOL concluded that the addition of a deemed IRA would not subject any part of the plan or the deemed IRA to ERISA Title I if the plan continues to meet the definition of a governmental plan.

Defined Benefit Plans

Qualified Joint and Survivor Annuity Notice

The Treasury Department and IRS on July 15, 2003 issued final regulations regarding the provision of the qualified joint and survivor annuity (QJSA) notice after a participant's annuity starting date. The final regulations allow a company to make retroactive annuity payments where a company could not provide the employee the necessary information before the employee first became eligible for benefits. The final regulations apply to plan years beginning on or after January 1, 2004.

Tax on Reversion of Pension Plan Assets

On July 1, 2003, the IRS issued Revenue Ruling 2003-85, providing that an employer that transfers at least 25 percent or more of the excess assets from a terminated defined benefit plan to a defined contribution plan will not be subject to any excise tax. In addition, such transfer of assets will not be included in the employer's gross income subject to federal income tax, and the employer cannot take a deduction for the amount transferred. Previously, amounts transferred that exceeded 25 percent of the excess assets were subject to a 20 percent excise tax, were included in the employer's gross income, and were subject to the deductible and contribution limits of the replacement plan. An employer is still subject to a 50 percent excise tax on any assets that revert to the employer upon a plan termination. This excise tax is reduced to 20 percent if a qualified replacement plan is established. The revenue ruling does not specifically address transfers to qualified replacement plans that are not a defined contribution plan, although that is the most common transfer situation.

Notice of Significant Reduction in Rate of Future Benefit Accrual

The IRS published final regulations on April 9, 2003, on the notice requirement for defined benefit pension plan amendments that significantly reduce the rate of future benefit accrual, or eliminate or significantly reduce an early retirement benefit or retirement-type subsidy (Section 204(h) notices). The final regulations include a number of examples, such as 204(h) notices for cash balance plan conversions where the future rate of benefit accrual may be reduced for some participants and increased for others. The final regulations generally apply to amendments that are effective on or after September 2, 2003.

Cash Balance Plans

The IRS announced April 7, 2003 that it was withdrawing one portion of the proposed cash balance regulations published in December 2002 (Announcement 2003-22). The IRS said that it was withdrawing the special rules in the proposed regulations that "eligible" cash balance plans were to use to demonstrate that they met the general nondiscriminatory benefit rules under Code Section 401(a)(4), which prohibits discrimination in favor of highly compensated employees. The IRS did not withdraw the proposed regulations on age discrimination under Code Section 411(b), published at the same time.

Other Retirement Plan Guidance—FASB

Although the Financial Accounting Standards Board (FASB) is not a government regulatory agency, it issued some significant guidance this year affecting employer retirement plans.

Pension Plan Disclosures

On December 23, 2003, FASB issued a revised version of the Statement of Financial Accounting Standards No. 132: Employers' Disclosures about Pensions and Other Postretirement Benefits (FAS 132). The new FAS 132 replaces the prior version and makes several significant changes to the required disclosures for pension and other postretirement benefit plan assets, obligations, and net cost in company financial statements. The new FAS 132 requires companies to provide users a breakdown of plan assets by major asset category, and also requires narrative disclosures of investment policies and strategies, and a separate narrative description of the basis used to determine the overall expected long-term rate of return on assets assumption. Another major new disclosure item is a summary of expected benefit payments for the next ten years. The new FAS 132 is generally effective for fiscal years ending after December 15, 2003. Interim-period disclosure requirements are effective for interim periods beginning after December 15, 2003. A delayed effective date applies to certain disclosures for foreign plans and for nonpublic entities, and to the disclosure of expected benefit payments.

Accounting for Cash Balance Plans

At its May 28, 2003 meeting, FASB ratified two conclusions made by the Emerging Issues Task Force (EITF) related to FAS 87 accounting for cash balance plans. The EITF conclusions were that cash balance plans should be accounted for as defined benefit plans and that the traditional unit credit cost method should be used as the attribution method for these plans. Both of these conclusions were consistent with most expectations. It is anticipated that the official guidance, when issued, will be prospective. It is also anticipated that the guidance will specify when and how the change in the projected benefit obligation (PBO) associated with a movement to the traditional unit credit cost method should be reflected in expense for any plan affected by the guidance.

The Board did not approve a related interpretation that would have required the FAS 87 obligations for a typical cash balance plan to be calculated using assumptions that are more conservative than those required for other plans. In response to outside comments criticizing this interpretation, the Board decided that it needed to study this issue in more depth. The Board directed the FASB staff to prepare additional information on this issue, which the Board will use to decide if the issue needs to be covered in separate guidance.

Regulatory Guidance—Health and Welfare Benefit Plans

Medicare

Medicare Prescription Discount Card

On December 10, 2003, the Department of Health and Human Services (HHS) issued interim final rules to implement the prescription drug discount card program enacted under the new Medicare law. The discount card program will begin in June 2004 and will end December 31, 2005 with a transition period. Under the program, beneficiaries will have a choice of at least two Medicare-approved cards but will be able to enroll in only one program at a time.

The cost of enrollment can be no greater than $30 per year, and HHS expects that beneficiaries will save 10 percent to 15 percent on their drug costs, with savings of up to 25 percent or more on individual prescriptions. Low-income beneficiaries will receive a subsidy of up to $600 per year and will not have to pay the enrollment fee. Retirees in employer-provided plans are not eligible for the $600 subsidy unless they are in a Medicare+Choice (now called Medicare Advantage) plan with no supplemental drug coverage. The regulations require drug card sponsors to pass through savings to beneficiaries and to publish the prices for the drugs that their cards will cover.

Medicare+Choice

The Centers for Medicare and Medicaid Services (CMS) published final regulations on April 1, 2003, to provide Medicare beneficiaries with new appeal rights and financial protections when their Medicare+Choice plan decides to terminate coverage of certain services. Under the final rules, written notice must be provided at least two days before the termination of specified services. A beneficiary who wishes to contest a decision to terminate services has the right to an immediate review by an independent review body.

Disease Management in Medicare

On February 27, 2003, the Department of Health and Human Services (HHS) announced that it is soliciting proposals from health care organizations for capitated disease management demonstration projects for Medicare beneficiaries with certain chronic diseases, e.g., stroke, congestive heart disease, diabetes, and other chronic health conditions. Health care organizations participating in the three-year demonstration projects will receive a capitated payment rate for all Medicare-covered Part A and Part B services.

Health Savings Vehicles

Health Savings Accounts (HSAs)

On December 22, 2003, the IRS and Treasury Department issued Notice 2004-2 providing basic information and guidance about HSAs in question-and-answer format, as enacted under the new Medicare law. HSAs are individual accounts that can be accumulated or distributed on a tax-free basis to pay or reimburse qualified medical expenses in connection with a high deductible health plan. Individuals eligible to establish an HSA are covered under a high-deductible health plan, do not have other duplicative coverage that is not a high-deductible health plan, are not entitled to Medicare, and may not be claimed as a dependent. A high-deductible health plan is one that has an annual deductible of at least $1,000 and a maximum annual out-of-pocket limit of $5,000, with certain exceptions. Family coverage amounts are double the self-only amounts. Although HSAs are individual accounts, employers may offer and contribute to an HSA through a cafeteria plan. The IRS and Treasury have requested comments on the guidance provided in Notice 2004-2 and they ask for particular guidance regarding such issues as the relationship between HSAs and FSAs or HRAs, the application of the cafeteria plan nondiscrimination rules to HSAs offered under a cafeteria plan, and whether transition relief should be provided for inappropriate coordination of a high-deductible health plan and other coverage.

Health Care Reimbursements

Debit or Credit Cards

The IRS issued Revenue Ruling 2003-43 on May 6, 2003, regarding the payment of medical expenses using a credit or debit card linked to a health care flexible spending arrangement (FSA) or health reimbursement arrangement (HRA). Plan sponsors were concerned about using credit/debit cards linked to FSAs/HRAs, in part, because of concern that the card would not meet the IRS rules requiring substantiation of medical expenses. The revenue ruling sets out three approved methods for plan sponsors to meet the substantiation requirements: 1) automatic substantiation for certain types of expenses, such as a set copayment for a doctor's office visit; 2) real-time substantiation by the service provider, pharmacy, etc. at the point of sale; and 3) conditional approval, with the employee required to later submit receipts to substantiate the expense. A sampling technique, where only a small percentage of claims are reviewed, will not meet the substantiation requirements. The revenue ruling also includes guidance on correction procedures to be followed if an FSA/HRA reimburses for expenses that are later found not to qualify as medical care. The new Medicare law excludes these transactions from the 1099-reporting requirement.

Reimbursement of Over-the-Counter Drugs

On September 3, 2003, the IRS issued Revenue Ruling 2003-102, which confirms that over-the-counter drugs may be reimbursed under FSAs and HRAs. Over-the-counter medicines used to alleviate or treat personal illness or injuries qualify as "medical care" and may be reimbursed under a health care FSA or HRA. However, dietary supplements (such as vitamins) to maintain the health of an employee do not qualify as medical care. The IRS clarification is effective immediately. Note that an employer health FSA or HRA is not required to reimburse for over-the-counter drugs and still has the option of defining what will be reimbursed under the plan.

Retiree Health

Age Discrimination in Employment Act

On July 11, 2003, the Equal Employment Opportunity Commission (EEOC) released proposed regulations that would allow employers to alter, reduce, or eliminate retiree health benefits when retirees become eligible for Medicare or a State-sponsored retiree health benefits program without violating the Age Discrimination in Employment Act (ADEA). The regulation was issued in response to the U.S. Third Circuit Court of Appeals decision in *Erie County Retirees' Association v. County of Erie*. The EEOC created an exemption from the general rule under Section 9 of the ADEA that allows the EEOC to establish reasonable exemptions it may find necessary and proper in the public interest. The exemption applies only to retiree health benefits and would apply to existing and newly created retiree health plans. The regulations will become effective when final regulations are published. The Senate version of the Medicare bill originally contained statutory language that would have explicitly allowed employers to provide lesser health benefits to Medicare-eligible retirees. However, the final law deleted this provision and added a statement in the legislative history that Congress believes that the provision of lesser health benefits to Medicare-eligible retirees complies with the ADEA. While the legislative history may or may not sway other courts hearing similar cases, it may help the EEOC because it is further proof of legislative intent.

COBRA Notices

The Department of Labor (DOL) published proposed regulations on May 28, 2003 on the notice requirements for COBRA health care continuation coverage that provide minimum standards for the timing and content of required notices to participants and beneficiaries, and also establish standards for administering the notice process. The proposed regulations generally reflect accepted COBRA practices but introduce two new notice requirements. First, plan administrators would be required to notify individuals if continuation coverage is determined not to be available. Second, plan administrators would be required to provide notices when COBRA continuation coverage terminates before the end of the maximum COBRA period. The proposed regulations include two model forms that may be used by administrators of single-employer group health plans to satisfy COBRA notice requirements. Use of the model forms will comply with the proposed regulations but is not required. Until final rules are issued, COBRA plan administrators are permitted to use the model notices contained in the proposed regulations to satisfy COBRA notice requirements.

HIPAA

Electronic Transactions and Code Sets Standards

The Centers for Medicare and Medicaid Services (CMS) issued guidance on July 24, 2003 on compliance with the Health Insurance Portability and Accountability Act (HIPAA) electronic transactions and code sets (TCS) standards. The guidance states that covered entities must be in compliance with the TCS standards by October 16, 2003, but that CMS will focus on obtaining voluntary compliance and will use a "complaint-driven" approach to enforcement. If CMS receives an individual complaint about a covered entity, it will notify the entity in writing, and the entity will have the opportunity to demonstrate compliance, document its good faith efforts to comply, or submit a corrective action plan. The guidance provides examples of indications of "good faith," as well as CMS's expected enforcement process.

Privacy of Medical Information

On April 17, 2003, the Department of Health and Human Services (HHS) published an interim final rule that establishes enforcement procedures for noncompliance with the HIPAA privacy standards. The new enforcement procedures apply to investigations, imposition of penalties, and hearings conducted as the result of a proposed imposition of civil monetary penalties. The new guidance is the first installment of an enforcement rule. The interim final rule became effective May 19, 2003 and expires September 16, 2004.

Security and Transaction Standards

On February 13, 2003, the Department of Health and Human Services (HHS) released final regulations on HIPAA security standards for protecting individually identifiable health information that is transmitted electronically and final rules on the HIPAA electronic data transaction standards. The security regulations require covered entities to implement various safeguards to protect individually identifiable health information while it is in their custody and while the information is in transit. The standards are framed in what HHS views as "generic" terms, allowing covered entities to use various technologies or means to satisfy the standards. Most covered entities have until April 21, 2005 to comply with the security standards regulations. The electronic data transaction regulations adopt modified standards for premium payments and coordination of benefits. Compliance was required by October 16, 2003.

Medical Expenses

Definition of "Medical Expenses"

The IRS issued two revenue rulings on May 15, 2003 to clarify whether certain specific expenses meet the definition of "medical care expenses" under Code Section 213. Revenue Ruling 2003-57 clarifies that breast reconstruction surgery following a mastectomy for cancer, and eye surgery (such as laser eye surgery) are considered medical care expenses. However, tooth-whitening procedures for teeth discolored because of age do not meet the definition, because the discoloration is not a deformity and is not caused by a disfiguring disease or treatment. Revenue Ruling 2003-58 clarifies that amounts paid by an individual for nonprescription medicines or drugs are not allowable expenses. However, amounts paid by an individual for equipment, supplies, or diagnostic devices such as crutches or blood sugar test kits may be considered medical care expenses if they meet the requirements of Section 213(d)(1) that they are for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.

Exercise Equipment as a Medical Expense

The IRS released Information Letter 2003-0202, dated April 8, 2003, stating that taxpayers may deduct exercise expenses, including the cost of equipment to use in the home, if required to treat an illness (including obesity) diagnosed by a physician. The taxpayer must establish that the purpose of the expense is to treat a disease rather than promote general health, and that the taxpayer would not have paid the expense but for this purpose. The IRS opinion in information letters only applies to the taxpayer addressed under the letter, but gives an indication of the IRS's current thinking on specific issues.

Food and Drug Administration

Availability of Generic Drugs

On June 12, 2003, the Department of Health and Human Services (HHS) and the Food and Drug Administration (FDA) released a final rule regarding generic drugs to close perceived legal loopholes in the law. According to the Administration, under prior law, a pharmaceutical manufacturer could challenge a generic version that may violate the patents on its product and automatically delay approval of a generic version by 30 months per patent. The final rule would allow only one 30-month stay. In addition, the final rule would tighten requirements for drug patent listings. The Administration expects that the final rule will save Americans over $35 billion in drug costs over ten years. This final rule is complemented by changes in the Medicare law.

Medication Errors

On March 13, 2003, HHS Secretary Thompson announced two proposed rules from the FDA to help reduce medication errors. The first proposed rule would require standardized bar codes for most prescription drugs, and for nonprescription drugs commonly used in hospitals. The second proposed rule would revamp the current safety reporting requirements, including a requirement that companies subject to the FDA's post-marketing safety reporting rules (e.g., specified drug manufacturers and distributors) must submit to the FDA within 15 days any reports of actual or potential medication errors with their products. In coordination with the new proposed rules, the FDA is also using emerging technologies, such as automatic reporting systems, to promote greater patient safety.

Multiple Employer Plans

Welfare Benefit Funds

On July 16, 2003, the IRS issued final regulations regarding whether a welfare benefit plan is part of a ten or more employer plan under Code Section 419A(f)(6). The regulations clarify the meaning of "experience-rating arrangements with respect to individual employers" by aligning the definition with the legislative history that suggests that the statutory exception to limits on the deductions for contributions was made available in limited situations where the economics of the arrangement would prevent excess contributions. The regulations generally apply for employer contributions paid or incurred in an employer's first taxable year beginning after July 11, 2002 (the date proposed regulations were published). The IRS cautions that because the regulations only clarify current law, it should not be inferred that contributions that would be nondeductible under the regulations would be deductible if made before that date.

MEWAs

On April 9, 2003, the Employee Benefits Security Administration (EBSA) of the DOL published five sets of final regulations on multiple employer welfare arrangements (MEWAs). The regulations set forth specific criteria for determining whether a health plan is collectively bargained. Health plans that are collectively bargained are excluded from the definition of MEWAs and are, therefore, not subject to state laws that regulate MEWAs. In addition, the final rules provide guidance on MEWA reporting requirements related to Form M-1 (Annual Report for MEWAs and Certain Entities Claiming Exception (ECEs)) and the assessment of civil penalties for the failure to comply with MEWA reporting requirements. The final rules also describe procedures for administrative hearings for obtaining determinations from the DOL on the issue of whether a particular health plan is collectively bargained, as well as procedures for administrative hearings on the assessment of civil penalties for MEWA reporting failures.

Other Health Plan Guidance—FASB

On January 12, 2004, the Financial Accounting Standards Board (FASB) issued the final version of FASB Staff Position (FSP) FAS 106-a that allows companies offering post-retirement medical coverage to have the option of either reflecting the anticipated financial effects of the Medicare law immediately, or deferring recognition until the earlier of when the FASB resolves the outstanding accounting issues or if plan costs are remeasured. This is a major reversal of the position articulated by the FASB in mid-December that would not have allowed accounting results to reflect the new Medicare law until the FASB addressed the accounting issues. The FASB recognizes that they need to issue guidance quickly on the proper accounting treatment for the Medicare law and hope to issue guidance by the end of March 2004. Under the FSP, all companies with post-retirement prescription drug benefits will need to include some additional narrative information related to the Medicare law in their year-end reporting.

Regulatory Guidance—Labor Issues

Use of State Unemployment Funds for Paid Leave

On October 9, 2003, the Department of Labor (DOL) repealed earlier rules that allowed states the option of using state unemployment compensation funds to pay for family leave for employees. The Birth and Adoption Assistance Unemployment Compensation (BAA-UC) regulations published by the DOL in June 2000 were very controversial and had been challenged in court by employer groups. During the three years the rules were in effect, no state implemented such a plan. The repeal became effective November 10, 2003.

FLSA Overtime Rules

On March 27, 2003, the Department of Labor (DOL) released proposed regulations under the Fair Labor Standards Act (FLSA) to update the rules for determining when a "white-collar" employee is exempt from overtime requirements. These proposed regulations were the subject of much controversy and prompted Senator Harkin (D-IA) to add an amendment to the DOL appropriations bill to prevent the DOL from finalizing the regulations during the 2004 fiscal year. This amendment was not included in the omnibus appropriations measure the Senate will consider in early 2004, clearing the way for final regulations in 2004, though further Congressional action is possible.

Americans With Disabilities Act (ADA)

On February 3, 2003, the Equal Employment Opportunity Commission (EEOC) released a fact sheet for employers who are considering allowing an individual with a disability to telework (e.g., telecommuting) as a "reasonable accommodation" under the ADA. Employers can use existing telecommuting programs to meet the ADA reasonable accommodation requirement, but may have to waive certain eligibility requirements such as rules requiring employees to work for a certain period of time before applying for the program. Employers that do not have telecommuting programs may still need to allow a disabled employee to telecommute as a reasonable accommodation.

Regulatory Guidance—Executive Compensation (Including Stock Options)

Mutual Funds

On December 11, 2003, the Securities Exchange Commission (SEC) released proposed regulations that would require all mutual fund shares traded in a retirement plan to be received by the fund, its designated transfer agent, or a registered securities clearing agency by 4:00 p.m. eastern time to receive that day's price. The SEC proposal would effectively require retirement plan investors to make their trades much earlier than 4:00 p.m. because of the time it takes to administer the transactions and send them to the fund. The proposed rules are strongly opposed by the retirement plan industry. The House passed legislation that would exclude intermediaries from this deadline, and a bill was introduced in the Senate that contains a similar exemption. Comments on the proposed rule are due by February 6, 2004.

Split-Dollar Life Insurance

The IRS issued long-awaited final regulations on the tax treatment of split-dollar life insurance on September 12, 2003. The final regulations provide that if the employee owns the split-dollar life insurance policy, the employer's premium payments are treated as loans to the employee. As a result, the employee is taxed on the difference (if any) between the market rate of interest on the loan and the actual interest rate charged. If the employer is the owner of the policy, the employer's premium payments are treated as providing economic benefits to the employee. The economic benefits include the employee's interest in the policy cash value and current life insurance protection. Certain issues are not fully addressed in the final regulations, including the definition of "material modification" and whether a material modification made between January 28, 2002 and September 17, 2003 would preclude the use of certain of the transition rules provided in 2002 IRS guidance. The final regulations became effective for agreements entered into or materially modified after September 17, 2003. Separately, the IRS issued Revenue Ruling 2003-105 stating that certain transition rules provided in the 2002 split-dollar guidance expire on December 31, 2003.

Golden Parachute Payments
On August 4, 2003, the IRS published final regulations on golden parachute payments. Among other changes, the final regulations permit shareholder approval of payments to be made up to six months before the change-in-control event. For stock options, the final regulations follow the safe harbor method laid out in earlier guidance. The final regulations adopt a "one change" rule so that if a corporation undergoes a change of ownership or control because a person or group acquires 20 percent voting power or more when the majority of the board of directors is replaced, the other corporation involved does not undergo a change of ownership or control. The final rules also state that the definition of "gross fair market value" is the assets of the corporation or the value of assets being disposed of, determined without regard to any liabilities associated with the assets. The final regulations also retain the exemption for tax-exempt organizations but do not cover payments approved but not paid by the tax-exempt organization. The regulations became effective on August 4 and apply to any payments contingent on a change in control that occurs in 2004 and beyond.

Compensatory Stock Options
The IRS published final regulations on August 26, 2003, on the tax treatment of stock-based compensation under the related party transfer pricing rules governing qualified cost-sharing arrangements (Code Section 482). Among other provisions, the final rules retain the requirement that compensatory stock options must be taken into account when determining the costs of developing intangibles under qualified cost-sharing arrangements. The regulations also provide rules for measuring the cost of stock-based compensation for this purpose, generally allowing taxpayers a choice of measuring the cost based on the stock price at the date of exercise or the "fair value," as noted in financial statements at the date of grant. The final regulations generally became effective for stock-based compensation granted in taxable years beginning on or after August 26, 2003.

Stock Options in Connection With Change of Ownership or Control
The IRS released Revenue Procedure 2003-68 on August 1, 2003, to provide additional guidance regarding the valuation of stock options in connection with a change in ownership or control under Code Sections 280G and 4999. Among other provisions, the revenue procedure states that the value of a stock option will not be considered properly determined if the option is valued solely by reference to the spread between the exercise price of the option and the value of the stock at the time of change in ownership or control. Instead, the revenue procedure provides a voluntary safe harbor valuation method that will be considered to meet IRS requirements and be consistent with generally accepted accounting principles (GAAP). Other valuation methods will also be considered acceptable, as long as they are consistent with GAAP and take into account other factors set out by the IRS. The revenue procedure is effective January 1, 2004.

Transfer of Stock Options to Related Parties
On July 1, 2003, the IRS published proposed, temporary, and final regulations, and Notice 2003-47 intended to stop certain types of sales or other dispositions of non-statutory compensatory stock options granted to a related person. Notice 2003-47 states that the IRS intends to challenge the purported tax benefits of certain of these transactions as being promoted and used as a tax-avoidance mechanism. The regulations state that the specified transactions will not be treated as a transaction that closes the application of Section 83 with respect to the option, effective July 2, 2003.

Shareholder Approval of Equity Compensation

The Securities Exchange Commission (SEC) announced on June 30, 2003, the approval of new rules proposed and adopted by the New York Stock Exchange (NYSE) and the NASDAQ Stock Market generally requiring shareholder approval of equity compensation plans, including stock option plans. Shareholder approval will generally also be required for repricings and material plan changes but excludes equity compensation plans intended to meet qualified retirement plan rules of Code Section 401(a) (and parallel nonqualified excess plans that meet specified rules) and certain transactions related to mergers and acquisitions. On December 16, the NYSE issued question-and-answer guidance on the rules.

Incentive Stock Options

The IRS published proposed regulations on June 9, 2003, regarding the taxation of incentive stock options (ISOs) and options granted under employee stock purchase plans (ESPPs). The proposed rules consolidate prior guidance and include updated rules addressing current issues and practices, such as ISOs issued by limited liability companies and other entities that elect corporate tax treatment. The rules will become applicable 180 days after publication of final regulations, but taxpayers may rely on the proposed regulations for any ISO granted after June 9, 2003.

Regulatory Guidance—Tax-Exempt Organizations

Section 457 Deferred Compensation

On July 11, 2003, the IRS published final regulations on Code Section 457 deferred compensation plans of state and local governments, and tax-exempt employers. The final regulations state that grants of discounted options to acquire mutual fund shares trigger income to the grantee when there is no longer substantial risk of forfeiture (i.e., when the option vests). The amount of income is equal to the fair market value of the options, but the regulations offer no guidance on how to determine the value of the option on the date that risk of forfeiture lapses. The final regulations also provide guidance on a number of other topics related to the taxation and administration of 457 plans. The final regulations generally apply for taxable years beginning after December 31, 2001, with certain exceptions. The special rule for options does not apply to an option without a readily ascertainable fair market value (as defined under Code Section 83(e)(3)) that was granted on or before May 8, 2002.

The IRS issued Notice 2003-20 on May 1, 2003, regarding the rules for withholding and reporting for "eligible deferred compensation plans" under Code Section 457(b). Among other provisions, the notice affirms that withholding and reporting payments under 457(b) plans of state and local governments generally follow the procedures for qualified plans. Payments under 457(b) plans of other tax-exempt employers fall under the general rules of withholding and reporting for wages. The rules in the notice apply to deferrals and distributions from eligible 457(b) plans made after December 31, 2001.

Outlook for Federal Legislation and Regulations in 2004

Since 2004 is the second session of the 108th Congress, all proposed legislation not addressed in 2003 will automatically carry over into 2004. With the Presidential and Congressional election campaigns shifting into high gear, however, it will be difficult for Congress to reach consensus on many legislative items. In addition, the Congressional schedule is typically limited in an election year with a target adjournment of October 1, shorter workweeks to allow time for campaigning, and longer recess periods to accommodate the party conventions. So, while there will be lots of activity and debate, ultimately little sweeping or controversial legislation is likely to be enacted.

But there is a considerable amount of unfinished legislative business related to the federal budget and tax matters. Before adjourning at the end of 2003, the Senate failed to act on appropriations legislation to fund the government agencies for fiscal year 2004, which began October 1, 2003. The remaining unfinished appropriations bills were rolled into an omnibus appropriations bill that the House passed before leaving in December. Currently, the federal government is being largely funded at 2003 levels under a continuing resolution through January 2004. Although the Senate leadership would like to pass the omnibus appropriations bill in January 2004, some Senators would like to reopen parts of the omnibus bill to address their particular concerns. Congress also failed to extend some expiring tax provisions before adjourning in December, and pledges to act early in 2004 to provide a seamless extension of these laws.

These budget and tax bills also potentially address some significant provisions related to human resources and benefit programs.

Legislation Likely to Be Addressed Early in the Session

Cash Balance Plans

Contained in the pending omnibus appropriations bill is a provision that would prevent the Treasury Department from finalizing its age discrimination regulations regarding cash balance plans. This provision would require Treasury to offer proposed legislation that would provide transition relief for older and longer service workers affected by conversions from traditional defined benefit plans to hybrid plans. In addition, the related legislative history includes a statement that the amendment is not intended to call into question the validity of the cash balance or pension equity plan designs. If the omnibus bill is reopened, there is a risk that this legislative history will be removed.

The Treasury Department is planning to release a legislative proposal addressing whipsaw and age discrimination issues in pension plans, with employers cautiously watching to see what they propose.

FLSA Overtime Rules

An amendment to prevent the Department of Labor (DOL) from finalizing its regulations on overtime rules for white-collar employees in fiscal year 2004 had been added to the Senate version of the DOL appropriations bill. The provision was dropped in a conference agreement with the House and thus was omitted from the omnibus appropriations bill. If the omnibus bill is reopened in 2004, that may create an opportunity for certain Senators to try to add the prohibition back to the appropriations bill. Even if the prohibition ultimately fails and the DOL issues final regulations (as expected) in 2004, Members of Congress that oppose the regulations will try to use the Congressional Review Act to repeal the final rules. The first and only time the Congressional Review Act was used, Republicans were successful in repealing the ergonomics rules issued by the Clinton Administration.

Health-Related Tax Provisions

As part of the expected legislation extending certain expiring tax provisions, Congress is expected to complete an extension of the current mental health parity law. Although Congress extended through December 31, 2004 the current Mental Health Parity law under ERISA and the Public Health Service Act, they failed to make a conforming amendment to the Internal Revenue Code. It is expected that when Congress addresses the extenders package in January, it will conform the Code at that time.

Archer Medical Savings Accounts expired at the end of December. Congress intends to extend this provision through December 31, 2004 when it addresses the extenders package in January.

IRC Section 420 asset transfers permit the transfer of certain pension plan excess assets to a 401(h) account to pay for retiree health care costs in the current year. Although this provision does not expire until the end of 2005, Congress intends to extend it until December 31, 2013 in the extenders package.

Other Legislation to Be Considered in 2004

Retirement Plans

Pension Funding

Prior to adjourning in 2003, Congress failed to enact legislation that would have provided a temporary replacement for the 30-year Treasury rate because of disagreement in the Senate. Congress will try again in 2004, but the outlook for quick action is unclear.

The House approved two bills, one of which would provide for a two-year temporary replacement (H.R. 3108) and the other which included a two-year temporary replacement, with a correction to the lookback rules, and two years of deficit reduction contribution (DRC) relief for the commercial airline industry (H.R. 3521). The Bush Administration, which generally opposes DRC relief, eventually agreed to DRC relief for the airlines and the steel industry.

On December 9, 2003, the Senate reached a unanimous consent agreement to address H.R. 3108 in 2004. The agreement allows the Senate to consider the House bill with a two-year temporary replacement, with three amendments regarding the pension discount rate, DRC relief, and multiemployer plan relief. However, no timetable has been set for consideration.

Congress also intends to look at permanent replacement proposals in 2004. The Treasury Department would like to again advance the pension plan proposal it unveiled in July 2003. With respect to the 30-year Treasury rate, the Administration proposal would require defined benefit plans to shift, over a five-year period, to calculating both pension liabilities and lump-sum distributions using a yield curve based on corporate bond rates. The proposal would require that every company disclose plan assets and liabilities on a termination basis in the plan's annual reporting, and that plan information reported to the Pension Benefit Guaranty Corporation (PBGC) under ERISA Section 4010 (for companies with more than $50 million of plan underfunding) be made available to the public. The proposal would also place significant restrictions on plans that have a funding ratio below 50 percent (on a plan termination basis) and are sponsored by companies with a junk bond credit rating.

Although Congressional leaders initially gave the yield curve proposal a lukewarm reception, many in Congress were swayed by the assertion that the yield curve is a more accurate measure of pension liabilities, and the yield curve proposal was added to the National Employee Savings and Trust Equity Guaranty Act (NESTEG) bill approved by the Senate Finance Committee on September 17, 2003. (This legislation has no bill number because it has not yet been formally introduced in Congress.)

The Treasury Department is currently working on a paper regarding how a yield curve would be structured and also plans to release ideas on broader defined benefit plan issues such as requiring higher contribution limits to avoid DRC and whether companies in junk bond status should be able to increase liabilities or make plan amendments. These concepts may be part of the fiscal year 2005 budget proposal, but Treasury is working on these larger concepts, so that discussion about a permanent replacement of the 30-year Treasury rate takes place in the context of larger pension funding issues.

Retirement Plan Reform

On July 18, 2003, the House Ways and Means Committee approved legislation (H.R. 1776) to help individuals save for retirement. The bill includes provisions regarding defined contribution, defined benefit, and stock option plans. The House passed separate legislation (H.R. 1000) on May 14, 2003 to address the diversification of employer stock in defined contribution plans and investment advice. The NESTEG bill approved by the Senate Finance Committee in September also addresses employer stock concerns, investment advice, and nonqualified deferred compensation issues, discussed below. It is unclear at this time what, if any, action Congress will take on broader retirement plan reforms, though they would like to address the issue of employer stock in retirement plans.

Mutual Funds

The House, on November 19, 2003, passed a bill (H.R. 2420) by a vote of 418-2 that addresses the current mutual fund situation. The bill included a manager's amendment developed by Representatives Baker (R-LA) and Oxley (R-OH) that directs the SEC to issue rules preventing late trading but states that the rules must exempt broker-dealers, retirement plan administrators, and other intermediaries if they use procedures designed to prevent late trading. The procedures would be subject to an independent annual audit. Despite the broad bipartisan support in the House, the SEC proposed rules that would impose a hard 4:00 p.m. close on mutual fund trades with no exceptions.

Senators Dodd (D-CT) and Corzine (D-NJ) introduced a bill (S. 1971) on November 25, 2003 that would also provide an exemption for retirement plan administrators and other intermediaries to the hard 4:00 p.m. close rule proposed by the SEC. The intermediaries' related detection policies or procedures would be subject to SEC inspection. The bill would also require the SEC to issue rules requiring mandatory redemption fees on investors who violate fund prohibitions on market timing. This issue will be a hot topic in Congress this year.

Bankruptcy Reform

On March 20, 2003, the House approved a bankruptcy reform package (H.R. 975) intended to make it more difficult to file for Chapter 7 liquidation instead of Chapter 13 bankruptcy, which requires some repayment of back debts over time. The legislation contains several provisions related to retirement plans, including a measure to exclude assets in employer-sponsored retirement plans from the bankruptcy estate. Up to $1 million of assets in IRAs and Roth IRAs would also be protected in bankruptcy, with rollovers from retirement plans excluded from the $1 million threshold. In addition, the bill would increase the cap on benefits claims by employees entitled to priority under the Bankruptcy Code, and would require that bankruptcy courts reinstate retiree benefits modified by a company within the 180-day period prior to its bankruptcy filing. The Senate tried to move quickly on the bill, but supporters could not garner the 60 votes needed to proceed to a vote. It does not seem likely that the Senate will be able to approve legislation this year.

Individual Tax-Favored Savings Accounts

President Bush is expected to include new individual tax-favored savings accounts in his budget proposal for fiscal year 2005, as he did for fiscal year 2004. The proposal from last year would create new individual savings accounts called Lifetime Savings Accounts (LSAs) and Retirement Savings Accounts (RSAs), and a new type of employer-sponsored plan called an Employer Retirement Savings Account (ERSA) that would consolidate and replace current 401(k), 403(b), and governmental 457 plans and small employer plans. ERSAs would generally follow the existing 401(k) rules, but with simplifications. In the fiscal year 2005 budget plan, it is anticipated that the LSA proposal will contain some significant changes.

Social Security

Creating private accounts within the Social Security system will receive attention in 2004, and the Bush Administration is expected to raise the Social Security issue during the 2004 elections. However, no changes are expected.

Health Care

Medicare Reform and Prescription Drugs

As soon as the final Medicare and prescription drug legislation was passed in November 2003, and prior to adjourning for the year, Democrats in both the House and Senate introduced legislation (S. 1992, S. 1994, S. 1950, S. 1974, S. 1999, H.R. 3672) that would repeal or modify certain provisions in the new Medicare law. Such legislation includes efforts to repeal or modify HSAs, repeal the premium support demonstration project, close the "doughnut" hole in the Part D benefit, allow Medicare to negotiate prices with drug manufacturers, and broaden the importation of prescription drugs. We expect to see more such bills in 2004, but enactment is unlikely.

Covering the Uninsured

The national debate over covering the uninsured is likely to rise in volume and in intensity in 2004. The Bush Administration is expected to re-propose refundable tax credits and other targeted measures to improve coverage incrementally. Meanwhile, Congressional Republicans and Democrats will also be working on their own respective proposals. The Senate Republican Task Force on the Uninsured will be actively exploring various legislative approaches, even as the Democratic Presidential candidates continue to advance their own plans to expand coverage for the uninsured and finance it by perhaps rolling back the federal tax cuts enacted under President Bush. We do not expect much, if any, of this debate to result in broad-based legislation in 2004.

One concrete possibility for 2004, however, is the targeted proposal (S. 1693) by Senators Baucus and Grassley, which is also supported by House Ways and Means Chairman Thomas, to extend to the unemployed a refundable tax credit like the current 65 percent TAA health care tax credit. The tax credit generally can be used to pay for COBRA premiums, a state high-risk pool, or for individual coverage in limited circumstances. Many other proposals to increase access to the uninsured are expected to emerge in 2004.

On January 23, 2003, Senator Breaux suggested that all individuals be required to purchase a minimum, basic health insurance package, with coverage for lower-income individuals subsidized by the federal government and with grants to help states create coverage pools. Senator Breaux's reform outline also included, however, a controversial provision to require employers to maintain current spending levels. On the other end of the mandate spectrum, Senator Kennedy recommended on January 21, 2003, a mandate that all employers with more than five employees provide health coverage, a suggestion unlikely to advance in Congress absent a broader-based shift in the political balance of power, which is currently not anticipated by many forecasters.

Mental Health Parity

The Senate is expected to address legislation to expand the current mental health parity law to generally prohibit group health plans from imposing any treatment limitations or financial requirements with respect to mental health benefits unless comparable limits or requirements are imposed on medical and surgical benefits provided by the plan. The bill (S. 486, S. 1832) would allow plans to apply medical management techniques to mental health, such as utilization review and the contracting and use of a network. The Senate Health, Education, Labor, and Pensions (HELP) Committee is expected to mark up a modified version of S. 486 in 2004. One reported modification is the narrowing of the definition of mental health services subject to the law.

To buttress the argument in favor of expanding the law, on July 22, 2003, the President's New Freedom Commission on Mental Health in its final report found that "the nation's mental health care system is beyond simple repair," and that a "fundamental transformation" is needed. The commission concluded that the current mental health system unintentionally focuses on managing the disabilities associated with mental illness, rather than promoting recovery, and that the problems of the current system make it harder for people with mental illness and their families to access needed care. The commission report included six goals and a series of specific recommendations. Among its proposals, the commission recommended that mental illnesses be addressed with the same urgency as other medical problems, and that consumers' needs and preferences should drive the services they receive.

Genetic Discrimination
On October 14, 2003, the Senate unanimously approved legislation (S. 1053) that would prohibit discrimination on the basis of genetic information in health plans, and in employment. Specifically, insurers would be barred from requesting, requiring, or purchasing genetic information for underwriting, and would be prohibited from collecting genetic information prior to an individual's enrollment in a health plan. The bill would also establish federal privacy standards and protections for genetic information. Remedies for violations of the bill would be similar to the remedies available under HIPAA and Title VII. The Bush Administration supports the bill and the House may take up the bill in 2004.

Medical Errors
On March 13, 2003, the House passed the Patient Safety and Quality Improvement Act (H.R. 663) that is intended to reduce medical errors by providing legal protections for information voluntarily reported to a patient safety organization (PSO) for the purpose of quality improvement and patient safety. The bill differentiates patient safety information from other source documents with medical information, which would still be available subject to current laws. The proposal would authorize HHS to create a national database to share findings from patient safety information and would authorize grants to enable providers to adopt error-reduction technologies.

On July 23, 2003, the Senate HELP Committee unanimously approved similar legislation (S. 720) to improve patient safety and reduce medical errors. The Senate bill would establish a voluntary system through which medical providers could report medical errors to PSOs, which would then provide the data to a National Patient Safety Database on an unidentified basis. The data provided to the PSO could not be disclosed except under limited circumstances, and would not be subject to discovery or subpoena in connection with a civil, criminal, or administrative proceeding. The legislation is a high priority for Sen. Frist (R-TN) and other Congressional leaders.

Medical Malpractice Liability Reform
On January 16, 2003, President Bush outlined his position on medical liability reform, and encouraged Congress and states to enact legislation to modify malpractice rules. Following the President's outline, on March 12, 2003, the House approved legislation (H.R. 5) that would allow a claimant to recover the full amount of economic damages, and would cap non-economic damages at $250,000. The bill would also set a narrower standard for whether punitive damages could be awarded, and such damages would be limited to the greater of two times the amount of economic damages or $250,000. Contingent legal fees would be capped at 40 percent of the first $50,000 recovered, 33-1/3 percent of the next $50,000 recovered, 25 percent of the next $500,000 recovered, and 15 percent of any amounts recovered in excess of $600,000.

Facing greater opposition in the Senate, on July 9, 2003, the Senate defeated a bill (S. 11) similar to the House bill on a largely party-line vote. Democrats disputed claims that the caps would reduce the costs of medical malpractice insurance, instead favoring legislation to remove antitrust exemptions for the insurance industry, to reduce medical errors, and to penalize attorneys who file frivolous lawsuits. Senate Majority Leader Frist (R-TN) would like to bring the bill to the floor again in 2004.

Class Action Lawsuits
On June 12, 2003, the House approved the Class Action Fairness Act (H.R. 1115) that would make it easier to bring certain class action lawsuits, including health care lawsuits, to federal court rather than

state court. The intent is to facilitate the hearing of class action cases with nationwide implications in objective forums, and to curb practices of filing these cases in locations solely because they might be more favorable to plaintiffs.

In the Senate, where passage at first seemed unlikely, Republican leaders are hoping to pass a bill (S. 1751) in February. Several key Senate Democrats struck a deal with Republicans that they say would preserve class action lawsuits that belong in state court, allow the first or main person to bring a lawsuit to get more money than other plaintiffs, and would limit lawyers' fees in settlements where plaintiffs get a discount on products instead of monetary damages.

Association Health Plans

On June 19, 2003, the House passed a bill (H.R. 660) to create Association Health Plans that would allow small businesses to band together through national trade associations to offer health insurance to their employees. The bill would bar pricing based on health status, and no eligible worker could be denied coverage. In addition, the bill would impose solvency requirements beyond those required of large corporations and labor unions. Critics of the bill complain that older, less healthy workers could be excluded under the bill because it would waive state minimum coverage standards. The legislation faces an uphill battle in the Senate and is not likely to be passed there.

Patients' Bill of Rights

On February 5, 2003, Representative Norwood (R-GA) introduced two separate bills (H.R. 596, H.R. 597) addressing Patients' Bill of Rights issues, and Senate Democrats introduced their own proposal (S. 10) on January 7, 2003 for patient protection legislation. None of these bills received much attention. The consumer backlash against HMOs has subsided, in part, because managed care plans voluntarily modified many of the practices that triggered consumer complaints, and more employees enrolled in less restrictive PPOs. Barring a sudden shift in the Congressional climate, the Patients' Bill of Rights issue is unlikely to receive attention in 2004.

Executive Compensation

Nonqualified Deferred Compensation

On October 28, 2003, the House Ways and Means Committee approved a corporate and international tax reform bill (H.R. 2896) that includes changes to rules governing nonqualified deferred compensation plans. Among other provisions, the House bill would restrict plan distributions to certain situations, prohibit any acceleration of plan payments, and restrict the timing of deferral and payment elections. The provisions would generally be effective for amounts deferred after December 31, 2004, with certain exceptions.

On September 17, 2003, the Senate Finance Committee approved a pension reform bill (NESTEG) that also included nonqualified deferred compensation provisions that are similar to the provisions in the House bill with some additional restrictions, such as limiting the number of plan investment options, prohibiting the deferral of stock option and restricted stock gains, and repealing a moratorium on Treasury to issue guidance on nonqualified deferred compensation plans. The Senate bill also includes a provision that would tax the proceeds on corporate-owned life insurance policies, with certain exceptions.

The amount of revenue raised by the nonqualified deferred compensation provisions makes them very attractive as a way to pay for other tax law changes. It is, therefore, expected that these provisions will be enacted in 2004 either as part of the bills mentioned above or on another vehicle.

Labor Issues

Unemployment Benefits

At the end of 2003, Republicans let expire a program that provides 13 additional weeks of federal unemployment benefits after workers have exhausted their regular 26 weeks of state benefits. Democrats will likely seek to reinstate the additional benefit in 2004.

Time Off in Lieu of Overtime

The House Education and the Workforce Subcommittee on Workforce Protections approved the Family Time Flexibility Act (H.R. 1119) on April 3, 2003, to allow employers to offer workers who are currently eligible for overtime the option of choosing to receive compensatory time in lieu of overtime, at a rate of not less than 1-1/2 times their hourly rate. An employee could not be required to choose compensatory time in lieu of overtime as a condition of employment. An employee could not accrue more than 160 hours of compensatory time, and the employer would be required to provide monetary compensation for any unused compensatory time not used in the prior calendar year. The full House will try to address the bill in 2004, but it will face stiff opposition in the Senate.

Other Tax Issues

Child Tax Credit

On June 12, 2003, the House passed legislation (H.R. 1308) to increase the refundability of the child tax credit for lower-income families. The bill would also provide a number of additional tax breaks for members of the armed services.

The Senate approved its own version of H.R. 1308 on June 5, 2003 that would make fewer changes than the House bill, but, unlike the House bill, would also provide for a uniform definition of "dependent" for various tax code provisions. A House-Senate conference committee began meeting to resolve differences between the two bills, but they were not able to reach agreement in 2003. The Bush Administration continues to push hard for passage of a bill as soon as possible.

Military Tax Relief

The House and Senate unanimously approved similar bills (H.R. 1307) on March 20, 2003 to provide $835 million in tax breaks for members of the armed forces. Among other provisions, the bills would increase the tax-free death benefit for members of the armed services from $3,000 to $6,000, and would give reservists an above-the-line deduction for up to $1,500 for overnight travel expenses if they served more than 100 miles away from home (the Senate version has no cap). The bills would also make it easier for individuals on extended active duty to qualify for the capital gains exclusion when they sell their homes. The House and Senate need to work out the differences between the two bills and may do so in 2004.

Regulations to Watch for in 2004

Although the prescription drug benefit in the new Medicare law does not begin until 2006, regulations on implementing the new law will begin to emerge in 2004. Other key regulations to watch for include:

- More detailed guidance from the IRS regarding HSAs;
- Final guidance from the SEC regarding mutual fund late trading;
- Final DOL guidance regarding the overtime rules under Fair Labor Standards Act;
- Final DOL guidance regarding COBRA; and
- IRS guidance addressing the applicability of COBRA rules to HRAs;
- IRS guidance on the valuation of split-dollar life insurance arrangements.

Appendix

Notable Federal Court Decisions in 2003

Medicare-Endorsed Prescription Drug Discount Card

In September 2002, CMS issued a final rule implementing a prescription drug discount card program. In January 2003, CMS issued a solicitation of applications from entities interested in becoming drug card sponsors. On January 29, 2003, a federal district court issued a permanent injunction preventing the Bush Administration from implementing the discount card program. The injunction was issued at the request of the National Association of Chain Drug Stores (NACDS) and the National Community Pharmacists Association (NCPA), which filed a lawsuit claiming that the initiative lacks legislative authority.

With the new Medicare law, a prescription drug discount card is set to be implemented for 2004 and 2005 before the new drug benefit begins in 2006. The NCPA stated that pharmacies are waiting to see how the final rule governing the discount card program is structured but would not rule out seeking legal action to stop it.

"Any Willing Provider" Law

On April 2, 2003, the U.S. Supreme Court unanimously ruled in *Kentucky Association of Health Plans v. Miller* that ERISA does not preempt Kentucky's "any willing provider" (AWP) law that requires health insurers and HMOs to accept as part of their networks any health care provider in the geographical area who agrees to the HMO's terms and conditions for participation. The Court abandoned previous mechanisms for determining whether a state law is deemed to regulate insurance (and is thus not preempted by ERISA), including the application of the McCarran-Ferguson Act. Instead, the Court said that for a state law to be deemed to regulate insurance, it must satisfy two requirements. First, the state law must be specifically directed toward entities engaged in insurance. Second, the state law must substantially affect the risk pooling arrangement between the insurer and the insured. The Court ruled that the Kentucky AWP law satisfies both these requirements, and is therefore, not preempted by ERISA.

Managed Care

The U.S. Supreme Court ruled on April 7, 2003, that physicians who filed suit against a number of HMOs over an alleged failure by the HMOs to reimburse them for patient care are required to arbitrate their claims *(PacifiCare Health Systems, Inc. v. Book).* The physicians sued in federal court, arguing that the HMOs had violated the Racketeer Influenced and Corrupt Organizations Act (RICO) and other statutes by failing to reimburse them for health care services they had provided to patients covered by the HMOs' health plans. The HMOs moved to compel arbitration under contracts with the physicians, and the Court agreed that arbitration was appropriate, noting that it would be premature for the Court to address certain ambiguous provisions in the contracts involving limits on available remedies.

On February 11, 2003, the U.S. Court of Appeals for the Second Circuit ruled that ERISA does not preempt the right of a participant in a fully insured HMO offered by an employer group health plan to sue the HMO for injuries resulting from the HMO's refusal to authorize medically necessary treatment (*Cicio v. Vytra Healthcare).* The court held that the medical director's decision to deny treatment was both a medical treatment decision and a contract decision, and that suing an HMO under state malpractice laws, if based both on eligibility and treatment decisions, is not preempted by ERISA when the suit challenges a medical decision. In the past, other courts have often rejected malpractice claims as preempted by ERISA. However, the Second Circuit said that those precedents were no longer binding because of the new framework established by the Supreme Court in *Pegram v. Herdrich* (2000), which held that that HMO physicians that make "mixed eligibility and treatment decisions" were not ERISA fiduciaries.

Retiree Medical

In August 2002, the U.S. Court of Appeals for the Sixth Circuit ruled in *Cline v. General Dynamics Land Systems, Inc.* that a group of employees in the class protected by ADEA (age 40 and over) could pursue a claim against their employer for providing richer benefits to an older group of employees. The case involved a negotiated agreement between the employer and the United Auto Workers union to reduce retiree medical benefits. Under the agreement, employees who had reached age 50 by the effective date of the agreement were covered by the prior benefit (providing full coverage after 30 years of service). A group of employees age 40-49, who lost retiree health coverage under the new agreement, alleged they were discriminated against on the basis of age. On November 12, 2003, the U.S. Supreme Court heard oral arguments in the case. A decision will be issued sometime in 2004.

Cash Balance Plans

On July 31, 2003, the U.S. District Court for the Southern District of Illinois ruled in *Cooper, et al. v. The IBM Personal Pension Plan and IBM Corporation* that IBM's cash balance plan was age discriminatory. The court determined that IBM's cash balance plan design, and the company's pension equity plan design previously in effect, violated the prohibitions against age discrimination because a participant's benefit accruals (expressed as an age 65 annuity) decrease as the participant ages. The court also determined that IBM's prior pension equity formula was age discriminatory because the formula reduces a participant's accrued benefit solely on increases in age or service.

Two of the plaintiffs' claims on issues other than age discrimination will proceed to trial. One is whether the conversion to a pension equity formula satisfied any of ERISA's three "anti-backloading" accrual rules and, the other is whether the conversion to a cash balance formula resulted in a partial plan termination. The court will also hear arguments regarding damages or other relief. The court must decide these issues at trial before IBM can appeal the ruling to the U.S. Court of Appeals for the Seventh Circuit.

On August 1, 2003, the U.S. Court of Appeals for the Seventh Circuit affirmed a 2001 decision in the Southern District of Illinois that the cash balance plan sponsored by the Xerox Corporation violated ERISA by the method it used to compute lump-sum benefits (*Berger, et al. v. Xerox Corporation Retirement Income Guarantee Plan*). The court determined that the plan violated ERISA by not including future interest credits in its computation of lump-sum benefits, and rejected Xerox's argument that departing employees are entitled only to the hypothetical cash balance account as of the date of departure.

Disability Plans

The U.S. Supreme Court ruled on May 27, 2003, in *Black & Decker Disability Plan v. Nord,* that ERISA does not require plan administrators to give special deference to the opinions of treating physicians when making disability determinations. The "treating physician rule" is used in making determinations under the Social Security disability program. The Court ruled that the Social Security Administration set out the treating physician rule for efficient administration of a mandatory benefits program, using a uniform set of federal criteria. In contrast, however, nothing in ERISA mandates that employers establish employee benefit plans or the kinds of benefits that must be provided. Instead, the Court said that employers have a lot of leeway to design disability and other welfare plans as they see fit. However, plan administrators may not arbitrarily refuse to credit a claimant's reliable evidence, including the opinions of a treating physician.

Family and Medical Leave Act (State Employees)

On May 27, 2003, the U.S. Supreme Court ruled that state employees may recover damages in federal court if the state fails to comply with the family care provision of the Family and Medical Leave Act (FMLA). The Court found in *Nevada Department of Human Resources v. Hibbs* that Congress had acted within its authority when it abrogated state immunity from suit in federal court for violations of the FMLA. It found that the FMLA met the heightened-scrutiny standard applicable to gender-based classifications because the provision served the government objective of preventing gender discrimination in the administration of leave benefits. In the case, a male employee of Nevada had requested FMLA leave to care for his wife, who was recovering from a car accident, but the employee alleged that he did not receive the full amount of FMLA leave to which he was entitled and was eventually terminated by the state.

Key State Health Care Legislation for Universal Coverage

"Pay or Play" Employer Health Care (California)

California Governor Gray Davis signed the Health Insurance Act of 2003 ("SB 2" or the "pay or play" bill) into law on October 5, 2003. The new law requires employers to either provide health insurance coverage for their employees meeting state law requirements or contribute to a statewide fund. The law also mandates who is eligible for coverage. Employers with 200 or more employees must cover employees and dependents and must comply with the mandate by 2006. Employers with 50 to 199 employees do not have to cover dependents and must meet the requirements of the mandate by 2007. Employers with 20 to 49 employees will be exempt unless the California legislature enacts a tax credit subsidy to assist in offsetting the cost of the insurance. Employers with fewer than 20 employees would be exempt from the law altogether. And there is an exception for collectively bargained plans.

Opponents of the law, lead by the Californians Against Government Run Health Care, are attempting to place a referendum on the March 2004 ballot to prevent the law from being implemented. The group gathered 620,000 signatures and submitted them to the Secretary of State of California for certification. However, the petition was challenged in state court and was found to be defective and therefore, invalid. The decision is being appealed. If the referendum fails or fails to get on the ballot, the group intends to challenge the law in federal and state court. The state court suit would challenge that the law was improperly approved by the legislature because it is really a tax bill but did not receive a two-thirds majority vote. In federal court, the law will likely be challenged on the grounds that it is preempted by ERISA.

"Universal" Health Care (Maine)

On June 18, 2003, Maine enacted legislation to provide "universal" health insurance to its uninsured residents beginning in July 2004. The legislation establishes a public-private health insurance plan called "Dirigio," to offer low-cost health plans to certain self-employed individuals and employees of small businesses. The state will contract with private insurance carriers to offer coverage to self-employed individuals and employees of small businesses who work at least 20 hours per week. Participating employers will pay as much as 60 percent of the premium cost, with premium subsidies to help lower-paid workers cover the remainder. The legislation also expands eligibility for the state's Medicaid program. The new law will be paid for, in part, by fees of as much as four percent of the gross revenues of health insurers.