Section 125.—Cafeteria Plans

(Also sections 106, 4980B.)

Cafeteria Plans. In an asset sale, transferred employees who have elected to participate in health flexible spending arrangements (FSAs) under the seller's cafeteria plan may continue to exclude salary reduction amounts and medical reimbursements from gross income without interruption at the same level of coverage after becoming employees of the buyer.

Rev. Rul. 2002–32

ISSUE

In an asset sale, may transferred employees who have elected to participate in health flexible spending arrangements (FSAs) under seller's I.R.C. § 125 cafeteria plan continue that benefit without interruption at the same level of coverage after becoming employees of buyer?

FACTS

Situation (1). Employer S maintains a cafeteria plan under section 125. One of the benefits available under the plan is a health FSA that provides for the reimbursement of participating employees' medical care expenses that are not covered by other insurance. To participate in the health FSA, employees elect pre-tax salary reduction for the right to receive medical care expense reimbursements during the plan year up to a maximum amount equal to the amount of the reduction elected for the year. Employer B is an unrelated business entity.

During a plan year, S and B enter into an agreement under which B acquires a portion of the assets of S and, as part of the acquisition, employees of S who work in connection with the acquired assets terminate employment with S and are transferred to and become employees of B. Employer B has, or agrees to create, a cafeteria plan that offers a health FSA through pre-tax salary reduction. It is the objective of both S and B that the administration of the transferred employees' health FSAs following the asset sale have as little impact on the transferred employees as possible. Following the sale, S will continue its business operations, including its health FSA. S and B agree that the transferred employees who have elected to participate in S's FSA will continue in S's FSA for the agreed upon period. S and B also agree on the extent, if any, to which the existing salary reduction elections made by the transferred employees for the FSAs under S's plan will continue as if made under B's plan.

Situation (2). Same facts as in Situation (1) except that, as part of the sale, B agrees to cover the transferred employees who have elected to participate in S's health FSA under B's health FSA. Under B's health FSA, the transferred employees will have the same level of coverage provided under S's health FSA and will be treated as if their participation had been continuous from the beginning of S's plan year. The transferred employees' existing salary reduction elections will be taken into account for the remainder of B's plan year as if made under B's health FSA. To implement this arrangement, B amends its plan documents to provide that transferred employees who elected to participate in S's health FSA become participants in B's health FSA as of the beginning of S's plan year and at the level of coverage provided under S's health FSA, except that transferred employees who continue participation in S's health FSA after the sale (*e.g.,* by election of COBRA continuation coverage) are not covered by B's health FSA for that year. In addition, B's health FSA is amended to provide for reimbursement of medical care expenses incurred by the transferred employees at any time during S's plan year (including claims incurred before the sale), up to the amount of the employees' election and reduced by amounts previously reimbursed by S. Thus, medical care expenses incurred prior to the closing date of the sale but not previously reimbursed as well as medical care expenses incurred after the closing date of the sale are reimbursable under B's health FSA. S amends its plan documents to provide that the transferred employees cease to be eligible for medical care expense reimbursements from S as of the closing date, except to the extent of any COBRA continuation coverage election. S and B have determined that the agreements between them are consistent with applicable law.

LAW AND ANALYSIS

In general, section 106(a) provides that gross income of an employee does not include employer-provided coverage under an accident or health plan. Under section 105(b), an employee may exclude amounts received through employer-provided accident or health insurance if those amounts are paid to reimburse expenses incurred by the employee during the period of coverage for medical care (of the employee, the employee's spouse, or the employee's dependents) for personal injuries or sickness.

Section 125(a) states that no amount will be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits in the plan.

Section 125(d) defines a cafeteria plan as a written benefit plan under which all participants are employees, and the participants may choose among two or more benefits consisting of cash and certain qualified benefits.

Section 125(f) defines qualified benefits as any benefit not includible in the gross income of the employee by reason of an express provision of Chapter 1 of the Code other than certain specified benefits that are not qualified benefits. A qualified benefit includes employer-provided accident or health coverage under section 106(a) and reimbursements for medical care expenses under section 105(b).

Section 1.125–4 of the Income Tax Regulations provides the circumstances under which an employer can permit a cafeteria plan participant to change an existing election during a period of coverage and make a new election for the remaining portion of the period of coverage. Generally, cafeteria plan participants are permitted to make election changes if there has been a change in status event and the election change satisfies the consistency rule. An election change satisfies the consistency rule with respect to accident or health coverage only if the election change is on account of and corresponds with a change in status that affects eligibility for coverage under an employer's plan.

Under the asset sale described in both Situation (1), where transferred employees maintain their existing health FSAs under S's cafeteria plan, and in Situation (2), where B agrees to cover the transferred employees who have elected to participate in S's health FSA, there is no loss of eligibility for coverage under § 1.125–4. Therefore, transferred employees continue to be subject to their existing FSA elections and may not change those elections during the remainder of the plan year of the asset sale (unless an event occurs thereafter which permits an election change under § 1.125–4).

For COBRA purposes, transferred employees in Situation (1) do not suffer a loss of coverage under S's FSA during the plan year. Consequently, if S's FSA satisfies the requirements of Q&A-8(c) in § 54.4980B–2, there is no obligation to make COBRA continuation coverage available to the transferred employees with respect to their coverage under S's FSA. However, if S's FSA does not satisfy the requirements of Q&A-8(c) in § 54.4980B–2 and is otherwise subject to COBRA, then it will be obligated to make COBRA continuation coverage available beginning on the first day of the plan year after the current plan year. For additional information, see § 54.4980B–2, Q&A-8 and § 54.4980B–9. In Situation (2), the obligation of S to extend to COBRA qualified beneficiaries the right to elect COBRA continuation coverage is not affected by the coverage provided by B.

HOLDING

In an asset sale, transferred employees who have elected to participate in health FSAs under seller's cafeteria plan may continue to exclude the salary reduction amounts and medical expense reimbursements from gross income without interruption and at the same level of coverage after becoming employees of buyer either when seller agrees to continue its existing health FSAs for the transferred employees as described in Situation (1) or when buyer agrees to adopt a continuation of seller's health FSAs for the transferred employees as described in Situation (2).

EFFECT ON OTHER REVENUE RULING(S)

None

DRAFTING INFORMATION

The principal author of this revenue ruling is Shoshanna Chaiton of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact her at (202) 622–6080 (not a toll-free call).

Section 172.—Net Operating Loss Deduction

Procedures are provided that certain taxpayers with net operating losses incurred in 2001 or 2002 must follow on or before October 31, 2002, if they wish to apply, or elect out of, the new 5-year carryback period enacted by section 102 of the Job Creation and Worker Assistance Act of 2002. See Rev. Proc. 2002–40, page 1096.

Section 460.—Special Rules for Long-Term Contracts

26 CFR 1.460–4: Methods of accounting for long-term contracts.

T.D. 8995

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Mid-Contract Change in Taxpayer

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning a mid-contract change in taxpayer of a contract accounted for under a long-term contract method of accounting. A taxpayer that is a party to such a contract will be affected by these regulations.

DATES: *Effective Date*: These regulations are effective May 15, 2002.

Applicability Date: These regulations apply to transactions on or after May 15, 2002.

FOR FURTHER INFORMATION CONTACT: John Aramburu at (202) 622–4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1732.

The collection of information in these final regulations is in § 1.460–6(g)(3)(ii)(D). This information is required to enable taxpayers to make look-back computations when the income from a long-term contract has been previously reported by another taxpayer.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number.

The estimated average annual disclosure burden per respondent is 2 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained as long as their contents might become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 460 generally requires that long-term contracts be accounted for