Reimbursement for Transit Expenses Under Qualified Transportation Plans

Prepared by Abigail Darwin, Compliance Consultant
Employee Benefits Corporation

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Overview

Section 132(f) of the Internal Revenue Code ("Code") allows for the creation of "qualified" transportation plans that provide employees and employers with tax savings on parking and commuting costs. By participating in the plan, employees save on FICA and income tax withholding. Employers also save on FICA, FUTA and income tax withholding with respect to the employees that participate in the plan.

Qualified transportation plans generally allow employees to direct their employers to take out contributions from their salaries on a pre-tax basis to pay for eligible parking, transit pass and vanpooling expenses. In addition, Section 132(f) allows employers to reimburse employees for certain bicycle commuting expenses on a tax-free basis.

For a transportation plan to be "qualified" under Section 132(f), and to therefore be able to provide employees and employers with tax savings, a transportation plan must meet certain requirements, including limits on amounts that can be withheld from an employee's salary for parking and commuting expenses and the amounts that employers can reimburse employees for eligible transit and bicycling expenses.

The amounts that can be excluded from employee income on a tax-free basis for eligible parking, transit pass and vanpooling expenses are subject to inflation-adjusted monthly statutory limits. Bicycling benefits are subject to an annual statutory limit that is not adjusted for inflation. In 2017, the monthly statutory limit for parking is $255; the combined monthly statutory limit for transit passes and vanpooling expenses is also $255; and, the annual statutory limit for reimbursement of eligible bicycling expenses is $240 (i.e., $20/month).[1] Although an employee could claim the maximum statutory limits for both parking and transit pass/vanpooling expenses in the same month (allowing for pre-tax benefits of $510 per month), these benefits cannot be combined with bicycling benefits.

Section 132(f) generally requires employers to distribute vouchers to participating employees (in the amount of the employees' salary reductions) that can be exchanged for transit passes or vanpool rides. In limited circumstances, however, employers are permitted to reimburse employees on a tax-free basis in cash for transit passes and vanpooling expenses.

The circumstances under which an employer can provide cash reimbursement to employees for transit expenses can be confusing. This whitepaper attempts to help employers by clarifying and simplifying this area of the law.

Qualified Transit Expenses

Section 132(f) allows employees to pay for qualified transit expenses on a pre-tax basis. These transit expenses must be for the purpose of enabling the employee to commute between home and his/her place of employment using transportation on a public or private mass-transit facility or in a "commuter highway vehicle" (i.e., "vanpool").[2]

The types of mass-transit facilities available to employees differ by geographic region but, as a general

[1] Rev. Proc. 2016-55, 2016-45 I.R.B. 707 (2017 parking, transit and vanpooling limit); Code §132(f) (bicycle limit).
[2] Treas. Reg. §1.132-9.

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matter, mass-transit refers to forms of transportation designed to carry multiple people at the same time, such as trains, buses, subways and ferries.

A "commuter highway vehicle" is one which meets the following requirements:

- Has a seating capacity of at least six adults (excluding the driver);
- At least 80% of the mileage use can reasonably be expected to be:
    - for purposes of transporting employees in connection with travel between their residences and places of employment; and
    - on trips during which the number of employees transported for such purposes is at least half of the adult seating capacity of such vehicle (excluding the driver).[3]

Taxis generally do not qualify as "commuter highway vehicles," because most do not have seating capacity for at least six adults (excluding the driver), and it is unreasonable to expect that at least 80% of a taxi's mileage for a year will be used (i) for purposes of transporting employees between home and work and (ii) on trips during which the number of employees transported for such purposes will be at least half of the adult seating capacity (excluding the driver).

In addition, the Internal Revenue Service ("IRS") does not consider tolls for bridges, tunnels, turnpikes, or roads to be eligible expenses that can be paid (or reimbursed) on a pre-tax basis under a qualified transportation plan.

Payment Options

Transit payment options differ depending on geographic area and the terms of a given employer's transportation plan, but generally, the only approved payment options are those identified by the IRS as approved "vouchers." The IRS regulations describe "vouchers" as instruments that are accepted by a mass-transit operator as fare media or in exchange for fare media.[4]

Pursuant to IRS guidance, smartcards and terminal-restricted debit cards can also qualify as vouchers. IRS Revenue Ruling 2014-32 defines "smartcards" as "cards that contain a memory chip storing certain information that uniquely identifies the card and value stored on the card, and that can be used either as fare media or to purchase fare media." IRS guidance provides that if the value stored on a smartcard can be used only as fare media for a particular transit system, the smartcard qualifies as a voucher.[5]

In Revenue Ruling 2014-32, the IRS defines "terminal-restricted debit cards" as "debit cards that are restricted for use only at merchant terminals at points of sale at which only fare media for local transit systems is sold." These cards are generally pre-loaded each month with the amounts of employees' salary reductions under their qualified transportation plans. IRS guidance provides that so long as the debit card is "terminal-restricted" and can only be used at points of sale at merchant terminals at which only fare media for the particular transit system can be purchased, terminal-restricted debit cards qualify as vouchers.[6]

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[3] Code §132(f)(5)(B).
[4] Treas. Reg. §1.132-9, Q/A-16(b)(2). "Fare media" is not defined in the IRS regulations.
[5] Rev. Rul. 2014-32, 2014-50 I.R.B. 917, modifying and superseding Rev. Rul. 2006-57, 2006-47 I.R.B. 911.
[6] Id.

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Cash Reimbursement of Transit Expenses

In most cases, cash reimbursements to employees for transit expenses are not permitted. Employees participating in qualified transportation plans generally make elections, usually a month or more in advance, for how much they want their employers to take out of their salaries for transportation expenses, up to the maximum statutory limit. Employers are then generally required to distribute vouchers to participating employees that can be exchanged for transit passes or vanpool rides.

In limited circumstances, however, Section 132(f) allows employers to reimburse employees on a tax-free basis in cash for transit passes and vanpooling expenses. The IRS regulations provide that cash reimbursement for transit expenses is only permitted if the employer fails the "Readily Available" Test. Specifically, cash reimbursement for transit passes can only be provided "if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee."[7] IRS Rev. Rul. 2014-32 further prohibits employers from providing cash reimbursements in areas where a terminal-restricted debit card is "readily available."

"Readily Available" Test

If vouchers are "readily available," transit expenses cannot be reimbursed in cash. To determine whether vouchers are "readily available," there is a two-part test, and if the answer to either part is "no," the employer will fail the test and be able to reimburse its employees' transit expenses in cash.

"Readily Available" Test—Part I

Part one of the "Readily Available" Test requires employers to make a generally easy determination as to whether vouchers issued by voucher providers are acceptable as fare media in the employer's geographic area. If the answer is "yes," the employer passes this prong of the test. The IRS regulations do not define "fare media;" they only state that a voucher must be accepted by at least one mass-transit operator in an area as fare media or in exchange for fare media.

"Readily Available" Test—Part II

Part two of the "Readily Available" Test is more complex and requires an employer to make a determination as to whether vouchers are "readily available" to that particular employer. In determining whether vouchers are "readily available," employers must look at whether the voucher provider imposes certain kinds of financial and nonfinancial restrictions that make the vouchers not "readily available" to the employer.

A. Financial Restrictions

The IRS regulations provide that financial restrictions in the form of excessive charges for fare media can result in vouchers not being "readily available." Fare media charges pertain only to the fees that employers pay to the voucher providers for vouchers. The determination regarding whether fare media charges cause vouchers not to be "readily available" should be made with respect to each transit system voucher. If more than one voucher is available in a given geographic area, employers must consider the fees imposed for the

[7] Code §132(f)(3).

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lowest-cost monthly voucher. In addition, if transit system vouchers for multiple transit systems are required in an area to meet the transit needs of employees, the employer has the option of averaging the costs for each transit system voucher.[8]

The IRS applies a "1% Rule" when determining whether fare media charges prevent vouchers from being "readily available."[9] Under the 1% Rule, vouchers are "readily available" if the "average annual fare media charges that the employer reasonably expects to incur for transit system vouchers purchased from the voucher provider (disregarding reasonable and customary delivery charges imposed by the voucher provider, e.g., not in excess of $15) are not more than 1 percent of the average annual value of the vouchers for a transit system."[10]

For purposes of this calculation, an employer's cost equals the external costs that the employer reasonably expects to incur (over-and-above the value of the voucher) that are imposed by the voucher provider. Employers are prohibited from taking into account additional costs from sources other than the voucher provider, including storage, distribution, security, accounting and reconciliation costs.[11] In addition, external costs imposed by third-party intermediaries, such as brokers and third-party administrators, should not be taken into consideration when making the cost determination.[12]

If the average annual fare media charges exceed 1% of the average annual value of the vouchers for the transit system, then the vouchers are not "readily available," and employers in that geographic area may reimburse employees in cash for transit pass expenses. Contrarily, if the percentage is equal to or less than 1%, then the vouchers are considered to be "readily available," unless certain other non-financial restrictions apply.

The following example illustrates how an employer would determine whether its costs exceed the 1% threshold. Assume that in Utopia City, Vouchers-R-Us provides mass-transit vouchers in various denominations to local employers. Employers can purchase vouchers on a monthly basis in reasonably appropriate quantities. Utopia City has several different transit systems, including bus, rail, vanpool, and ferry, and all of these transit system operators accept the vouchers as either fare media or in exchange for fare media. To cover its operating expenses, Vouchers-R-Us imposes a $0.50 charge on each voucher, plus a reasonable and customary $10 delivery charge on each order of vouchers.

Acme, Inc., an employer in Utopia City, distributes vouchers purchased from Vouchers-R-Us to employees who participate in Acme's qualified transportation plan. Acme reasonably expects that $55 is the average value of the vouchers that it will purchase for the next calendar year from Vouchers-R-Us.

In this example, the vouchers would be considered "readily available," because the expected cost of the vouchers disbursed to Acme's employees for the next calendar year does not exceed 1% of the value of the vouchers ($0.50 divided by $55 equals 0.91%). Acme would disregard the delivery charges when making its calculations, because they are below $15 and are therefore reasonable and customary. Assuming there are no other non-financial restrictions that would make the vouchers not "readily available," Acme should

[8] Treas. Reg. §1.132-9, Q/A-16(b)(5).
[9] Id.
[10] Id.
[11] IRS Information Letter 2001-0090 (Mar. 16, 2001).
[12] Treas. Reg. §1.132-9, Q/A-16(b)(3).

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purchase and distribute vouchers to its employees and not reimburse its employees in cash for transit expenses.

B. Non-Financial Restrictions

For a voucher to be considered "readily available," the voucher provider also cannot impose certain non-financial restrictions that effectively prevent the employer from obtaining vouchers appropriate for distribution to its employees.[13]

The IRS regulations provide three examples of nonfinancial restrictions that may cause vouchers to not be "readily available," regardless of the outcome of the 1% Test. These include:

- Unreasonable Advance Purchase Requirements. Advance purchase requirements imposed by a voucher provider could be considered unreasonable and cause a voucher to not be "readily available" if either:
  - the voucher cannot be purchased at "regular intervals" (e.g., monthly intervals); or
  - the voucher provider does not provide the vouchers within a reasonable period of time after receiving payment for the voucher.

  The Regulations do not explain what constitutes "delivery within a reasonable period of time" or "regular intervals." They only explain that vouchers that can only be purchased once a year are not able to be purchased at "regular intervals."[14]

- Unreasonable Purchase Quantity Requirements. A voucher provider imposes unreasonable purchase quantity requirements if it does not offer vouchers in quantities that are "reasonably appropriate" to the number of a given employer's employees who use mass-transit systems.

  The Regulations do not explain what is meant by "reasonably appropriate." They do provide an example, however, that it would be unreasonable for a voucher provider to require a $1,000 minimum purchase for an employer who only wants to buy $200 of vouchers.[15]

- Inappropriate Limitations on Denominations That Are Available for Purchase. If the denominations of vouchers available for purchase from the voucher provider are inappropriate, this could constitute an unreasonable restriction that would make the vouchers not "readily available." The IRS guidance says that for example, vouchers provided in $5 increments up to the maximum monthly limit would be appropriate for distribution to employees, while vouchers available only in a denomination equal to the monthly limit would not be appropriate if employees' expenses were usually less than the monthly limit.[16]

State Laws and Local Ordinances

A growing number of cities and states are requiring or incentivizing employers to offer transit benefits to their employees, in part to encourage employees to use public transportation and preserve the

[13] Treas. Reg. §§1.132-9, Q/As-16(b)(6).
[14] Treas. Reg. §1.132-9, Q/A-16(b)(6)(i).
[15] Treas. Reg. §1.132-9, Q/A-16(b)(6)(ii).
[16] Treas. Reg. §1.132-9, Q/A-16(b)(6)(iii).

environment. Currently, five cities and one region—the San Francisco Bay Area, which includes nine counties—have laws requiring employers to provide pre-tax transportation benefits to their employees. These ordinances apply to the following types of employers:

- In New York City, employers with 20 or more full-time (30+ hours per week) employees;
- In Washington, DC, employers with 20 or more total employees;
- In San Francisco, CA, employers with 20 or more full-time (10+ hours per week) employees;
- In Berkeley, CA, employers with 10 or more full-time (10+ hours per week) employees;
- In Richmond, CA, employers with 10 or more full-time (10+ hours per week) employees;
- In the San Francisco Bay Area (9 counties), employers with 50 or more full-time (20+ hours per week) employees.

In 39 states, employers and employees can save on state income and payroll taxes, in addition to federal taxes. These states include: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Nebraska, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Dakota, Utah, Vermont, Virginia, West Virginia and Wisconsin.

Some states provide additional tax incentives, including tax credits, for employers who offer transit benefits to their employees. Employers should consult with their tax advisor to find out whether their state provides any such incentives and whether they would qualify for such benefits.

Conclusion

As a result of the tax savings that qualified transportation plans provide to both employers and employees and the fact that more cities and states are adopting laws mandating and incentivizing employers to provide transit benefits, commuter benefits will likely continue to become increasingly widespread in future years.

Employers that offer qualified transportation plans may sometimes be asked by their employee-participants to reimburse the employees in cash for transit expenses. Employers should understand, however, that the IRS severely limits the circumstances under which employers can do this. As a general rule, employers are required to distribute vouchers to employees with values corresponding to the employees' pre-tax salary reductions. Employers are only allowed to provide cash reimbursement if transit vouchers are not "readily available."

Because vouchers are generally "readily available" in most geographic areas, employers should use caution before agreeing to reimburse their employees in cash for transit expenses. Providing cash reimbursement in situations where vouchers are "readily available" could result in significant tax penalties for the employer and employees and possible disqualification of the employer's transportation plan.

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