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OFFICE OF THE CHIEF COUNSEL

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Dear _____ :

This letter responds to your request for information dated December 22, 2009 in which you asked several questions about the tax consequences of certain employer-provided transportation benefits. This letter first provides an overview of the tax treatment of these transportation benefits. It then answers your specific questions.

Employers that provide their employees with transportation benefits can exclude those benefits from their employees' gross incomes if the benefits are "qualified transportation fringes" [section 132(a)(5) of the Internal Revenue Code ("the Code")]. We understand that your questions pertain to two types of qualified transportation fringes employers frequently provide through the use of smartcards: transit passes and qualified parking. Accordingly, this letter focuses on the tax treatment of transit passes and qualified parking that employers provide by crediting their employees' smartcards. We note that an employer may provide both transit passes and qualified parking on a tax-favored basis to an employee in a given month, as long as each benefit separately meets the requirements described below.

Transit Passes

A "transit pass" is any pass, token, farecard, voucher, or similar item (including an item exchangeable for fare media) that entitles a person to transportation on mass transit facilities [Code § 132(f)(5)(A)].¹ Transportation benefits employers provide through smartcards, debit or credit cards, or other electronic media are considered "transit passes" only if the fare media value stored on the cards is useable only as fare media for a mass transit system and the amount allocated to the cards each month does not exceed the maximum amount which may be excluded from gross income and wages

¹ The Code's definition of transit pass also includes a pass, token, farecard, voucher, or similar item that is provided by any person in the business of transporting persons for compensation or hire in a highway vehicle with a seating capacity of at least six adults (excluding the driver) [Code § 132(f)(5)(A)].

[See Rev. Rul. 2006-57, 2006-47 I.R.B. 911]. For the purposes of this letter, we will assume that a smartcard segregates qualified parking benefits so that fare media for mass transit provided via the smartcards meets this definition of “transit passes”

Employers may provide employees with tax-free transportation on a mass transit system by distributing transit passes to their employees. In 2010, an employer is entitled to exclude up to \$230 per month of such benefits from an employee’s gross income and wages. Substantiation of the use of these transit passes is not a requirement for receiving the tax-favored treatment. [Tax Regulations (“the Regulations”) § 1.132-9, Q&A 18-19]. Employers may credit up to \$230 in transit pass benefits to their employees’ smartcards each month on a tax-free basis without requiring the employees to show how they use the transit benefits.

Qualified Parking

“Qualified parking,” is parking that is located on or near the employer’s business premises or on or near a location from which the employee commutes to work via mass transit or commuter highway vehicle [Code § 132(f)(5)(C)]. In 2010, an employer is entitled to exclude up to \$230 per month of such benefits from an employee’s gross income and wages.

Employers may provide parking benefits only by reimbursing their employees for “qualified parking” expenses that they in fact incurred.² Rather than reimbursing their employees in actual cash, some employers may choose to make “cash” reimbursements by crediting the reimbursed amounts onto employees’ smartcards. The Regulations provide that employers that make cash reimbursements must establish a “bona fide reimbursement arrangement.” Although precisely what constitutes such an arrangement is a question of facts and circumstances, it must be an arrangement that is reasonably calculated to ensure that the employee in fact incurred expenses in an amount equal to the reimbursement [Regulations § 1.132-9, Q&A 16(c)]. Common characteristics of such arrangements include requirements that employees provide employers with receipts or other records substantiating the parking costs that they incurred.

Salary Reduction and Salary Supplement Arrangements

Employers may provide employees with transit passes or parking benefits either (1) in addition to employees’ stated compensation (salary supplement), or (2) by reducing employees stated compensation (salary reduction). For purposes of responding to your questions, we assume that what you referred to in your inquiry as “employer provided funds” are salary supplement arrangements, while what you referred to as “pretax funds” are salary reduction arrangements. In a salary supplement arrangement, an

² Although we believe it is outside the scope of your inquiry, we do note that it is also possible for employers to provide employees with qualified parking in kind.

employer offers to fund the cost of a qualified transportation fringe benefit over and above the amount the employer pays to the employee in salary. In a salary reduction arrangement, the employee is allowed to designate a portion of the amount he would otherwise receive as salary to be set aside to fund qualified transportation fringe benefits that he then receives from the employer. The amount of the salary supplement or salary reduction is excluded from the employee's income and wages for federal tax purposes provided that the salary supplement or salary reduction is used exclusively to fund qualified transportation fringes.

Employers may "roll over" excess salary reduction amounts. That is, when an employee elects to reduce her compensation for a month by an amount that exceeds the transportation expenses that she receives either in the form of transit passes or as reimbursements for qualified parking expenses actually incurred for that month, the employer may apply this excess towards qualified transportation fringes in subsequent months, as long as the employee does not receive an amount in excess of the maximum excludable amount in any month [Regulations § 1.132-9, Q&A 15]. Thus, if an employee elects a monthly salary reduction of \$200 to be used to reimburse qualified parking expenses, and the employee incurs only \$150 in qualified parking expenses for that month, the \$50 in salary reduction that exceeds the expenses can be rolled over and made available to reimburse parking expenses incurred in a future month. In no case, however, may the employer provide a refund of the amount by which the employee's salary reduction amounts exceed the actual qualified transportation fringes provided to the employee by the employer [Regulations § 1.132-9, Q&A 14]. In other words, an employee may use salary reduction amounts only for qualified transportation costs.

Your questions also make reference to circumstances where the amount of qualified transportation fringes provided to the employee by the employer exceeds the expenses incurred by the employee and the employee requests a "benefit refund." Qualified parking benefits may be provided solely as reimbursements for qualified parking expenses after they are incurred. Thus, we presume that your questions are referring to a circumstance where the employer has provided the employee with transit passes by crediting the employee's smartcard at the beginning of the month, and the employee has a balance for fare media remaining at the end of the month.

I will now address the specific questions you raised in your letter:

(1) Can the combination of rolled over funds plus new month funds exceed current monthly limits?

Yes, the sum of rolled over credits that an employee has accumulated on a smartcard from a prior month plus new month funds that are credited to the employee's smartcard in the current month may exceed the maximum monthly excludable amount.

Transit Passes: Because the Regulations do not require employers to distribute transit passes pursuant to bona fide reimbursement arrangements, it is possible for the value of the transit passes that employees receive to exceed the actual costs that they incur for transportation on mass transit facilities. Thus, the sum of any excess transit passes that an employee accumulates from prior months and transit passes that an employer makes available in the current month may exceed the monthly limit.

Parking Benefits: The regulations do not permit employers to provide employees with parking benefits that exceed parking costs that the employees actually incur. As employers are required to provide qualified parking benefits under a bona fide reimbursement arrangement, it is not possible for there to be any excess reimbursement. In this context there can consequently be no “rolled over funds.”

(2) If yes, are there any accumulation limits? (The Metro system limit is \$4045 per benefit)

Neither the Internal Revenue Code nor any of the Service’s administrative guidance specifies any accumulation limits.

(3) If no, what is the IRS recommended disposition of pretax or employer provided funds not rolled over and how is this reported?

In light of the answer to question 1, this question is not applicable.

(4) What is the IRS’ definition of a commuter?

Neither the Code nor Regulations explicitly define the term “commuter.” The Regulations do, however, specify the individuals who are eligible to exclude transportation benefits from their gross incomes. Section 1.132-9, Q&A 5 of the Regulations states that the individuals who may exclude qualified transportation fringe benefits from their gross incomes are those who “are currently employees of the employer at the time qualified transportation fringe is provided.” Section 1.132-9, Q&A 24 of the Regulations further clarifies that, for the qualified transportation fringe benefit rules, partners, sole proprietors, or other independent contractors are not employees, and that “2-percent shareholders of S corporations are treated as partners for fringe benefit purposes.”

(5) Are transit and parking benefits for the exclusive use by the employee between home and work travel? If there are other permitted uses, please provide examples, i.e. share with family members and friends, sell benefits for personal gain, use for non-work related travel, etc.

Transit Passes: The Regulations state that an employer may provide transit passes only to those individuals who are “currently employees of the employer at the time the qualified transportation fringe is provided.” Section 1.132-9, Q&A 18 of the Regulations states that there are no substantiation requirements if the employer distributes transit

passes. The Regulations do not, however, prohibit employers from independently requiring employees to certify, for example, that they used such transit passes only in connection with their own commutes from their residences to their workplaces [Regulations § 1.132-9, Q&A 19].

Parking Benefits: Like transit passes, the Regulations state that an employer may provide qualified parking only to those individuals who are “currently employees of the employer at the time the qualified transportation fringe is provided.” Unlike transit passes, though, these parking benefits may be used only by the employees themselves, and only in connection with their commutes to their places of employment. Section 1.132-9, Q&A 4 of the Regulations limits the exclusion to parking provided to an employee by an employer “[o]n or near the employer’s business premises,” or “[a]t a location from which the employee commutes to work.” The Regulations also require employers who provide parking benefits to establish bona fide substantiation arrangements, under which employers verify that the employees have incurred the costs themselves in connection with their travel between home and work [Regulations section 1.132-9, Q&A 16(c)].

(6) How should benefit refund requests from employees be treated and should pretax and employer paid benefits be treated differently?

We understand “benefit refund requests” to refer to instances in which an employee asks either an employer or a transit provider to convert unused transit passes that were originally provided as qualified transportation fringes into cash. (As qualified parking benefits are provided exclusively as reimbursements for expenses actually incurred, it is not clear to us how an employee could have a benefit refund request for qualified parking benefits.) A transit pass is a qualified transportation fringe only if it is useable only as fare media for a mass transit system. This requirement applies regardless of whether the employer uses a salary reduction or salary supplement to fund the transit pass that it provides to the employee. Thus, if employees could receive cash refunds for their unused transit passes, then the transit passes would not qualify as qualified transportation fringes.

(7) Should pretax benefit refund requests from an employee be returned to the employer for payroll adjustments?

See the response to the preceding question.

(8) Employers that offer a pretax benefits program would prefer to have unused amounts rollover for future use by their employees and employers that offer the benefits as a tax free benefit would like unused amounts returned to them as a credit. Do these differing treatments of benefits fall into an acceptable manner to address employer concerns?

As discussed earlier, if an employee funds transportation benefits under a salary reduction arrangement, and if the amount of the salary reduction for a given month exceeds the value of the transportation benefits that the employee receives, the employer may rollover this unused amount for future use by the employee. If an employee receives transportation benefits as a salary supplement, the only "unused" amounts would be transit pass amounts. (As noted above, qualified parking benefits are provided solely as reimbursements for expenses already incurred.) Nothing in either the Code or Regulations prohibits an employer that provides its employees with transit passes as salary supplements from requiring employees to return unused transit passes.

(9) Please outline the differences and similarities in the treatment of transit and parking benefits.

Please see the information set forth at the beginning of this letter.

(10) Can an employer establish their own internal guidelines to have the benefits limited to travel between home and work?

Yes. Section 1.132-9, Q&A-19 of the Regulations states that an employer may choose to implement substantiation requirements in addition to those described in IRS guidance.

This letter has called your attention to certain general principles of the law. It is intended for informational purposes only and does not constitute a ruling. See Rev. Proc. 2010-1, §2.04, 2010-1 IRB 1 (Jan. 4, 2010). If you have any additional questions, please contact our office at

Sincerely,

Lynne Camillo
Branch Chief
(Employment Tax Branch 2 (Exempt
Organizations/Employment Tax/Government
Entities) (Tax Exempt & Government Entities))