Transit Benefits: New Guidance from the Feds, New Mandate from NYC

Executive Summary

Congress, the IRS and even New York City have weighed in recently on the provision of transit benefits to employees. Recent guidance covers the following topics, which are described more fully in this Alert:

- Congress passed legislation retroactively increasing the monthly limit for tax-free transit and commuter highway vehicle benefits for 2014 to $250. *This retroactive increase does not increase the monthly limits for 2015, but might require changes to employment tax returns and W-2s for 2014.*

**Lockton Comment:** On Jan. 8, the IRS issued guidance subsequent to our initial release of this Alert. This guidance, discussed more fully below, contains important additional information, including a simplified method for obtaining a refund of over-withheld employment taxes.

- IRS guidance addresses the circumstances in which employers can provide employees cash reimbursements for transit expenses when debit cards, smart cards and other electronic media are available to provide qualified transportation plan benefits.

- Beginning in 2016, employers with 20 or more full-time employees in New York City are required to allow those full-time employees to reduce their salaries on a pretax basis to pay for transit costs.
Background

Employer-provided transit benefits that meet certain requirements in the tax code are not subject to federal income or employment taxes. Employers can provide these benefits either by paying for them or, more commonly, by establishing a salary reduction program allowing employees to choose to have the employer deduct, on a pretax basis, certain transit expenses. These "qualified" transportation fringe benefits include transit passes, qualified parking, and the cost of transportation in a commuter highway vehicle between home and work. They also include bicycle commuting reimbursement, but this benefit may be provided only via reimbursement from the employer, after the employee has incurred the expense.

*Lockton Comment:* The salary reduction program is similar to, but different from, a cafeteria plan, which may allow employees to pay health coverage premiums on a pretax basis or contribute to a health or dependent care flexible spending account on a pretax basis. The tax rules do not permit qualified transportation fringe benefits to be part of a cafeteria plan.

For 2015, the maximum tax-free benefit is $250 per month for qualified parking expenses, $130 per month for transit and commuter benefits, and $240 per year for bicycle commuting reimbursement. The maximum monthly reimbursement rate is adjusted for inflation each year; however, the annual bicycle commuter reimbursement amount is not adjusted.

Congress Provides for Retroactive Increase in Transit and Commuter Benefits

The disparity in limits between parking ($250 per month) and transit/commuter benefits ($130 per month) has been retroactively eliminated for 2014. This means employers - had their crystal ball foreseen Congress's retroactive adjustment - could have offered a $250 per-month combined benefit for transit and commuter transportation in 2014.

*Lockton Comment:* Proposed tax legislation often includes language temporarily or permanently making the transit/commuter benefit limit equal to the parking benefit limit. We may see such legislation again in 2015. Still, employers are encouraged to use the unequal limits for 2015 (i.e., $250 for parking and $130 for transit/commuter benefits) to avoid potential administrative and compliance hassles that will arise if parity legislation is not passed for 2015.

On Jan. 8 the IRS released guidance ([IRS Notice 2015-2](https://www.irs.gov/)) describing how employers and employees can take advantage of this retroactive increase. The IRS stated that salary reduction elections for 2014 cannot be retroactively increased, so employees of employers that only provided transit/commuter benefits via pretax salary reduction are not likely able to reap any advantage from the adjustment. The adjustment is more likely to affect employers that directly paid for transit/commuter benefits from the employer's
own funds.

**Lockton Comment:** Some salary reduction transit/commuter benefit plans allow employees to contribute above the maximum pretax limit, but provide that any amount above the pretax limit will be deducted after-tax. It is possible that the retroactive increase in the transit/commuter benefit limit could affect employees who reduced their salaries in excess of $130 per month in 2014, depending on the wording of the plan document and salary reduction agreements. Employers with these types of salary reduction arrangements will want to carefully review their plan documents and salary reduction agreements to determine whether the pretax benefit was limited to $130.

The guidance explains that employers that provided aggregate transit/commuter benefits in excess of $130 per month, and less than or equal to $250 per month in 2014, that are seeking a refund of the employer's portion of the over-withheld employment taxes have a duty to repay employees for their share of over-withheld employment taxes.

**Lockton Comment:** Unlike employment tax rules, income tax rules do not provide a mechanism for making adjustment to an employee's income tax withholding in the prior year. However, employers that have not already issued W-2s should incorporate the retroactive transit/commuter benefit increase when reporting taxable income, and employers that have issued W-2s should issue corrected W-2s. Employees then will need to make the necessary adjustments on their personal tax returns.

The process of obtaining a refund on employment taxes can be complicated, and employers should obtain the help of qualified tax advisors to assist with the details provided in the Notice that are summarized below. Different procedures outlined in the Notice apply, depending on whether the employer has filed its fourth quarter employment tax return (Form 941). In any event, employers will want to provide correct W-2 information, as described in the comment above.

The first step to correction, regardless of whether the employer has filed its 2014 fourth quarter Form 941, is to repay employees for the over-withheld amount. This can be done by a direct payment to the employee or by applying the amount of the over-withholding against the employee's share of future employment taxes.

If the employer has already filed its 2014 fourth quarter Form 941, then the employer claims a refund for both its share and the employee's share of the over-withheld employment taxes by submitting an amended Form 941 (Form 941-X) for each quarter in 2014. In addition to the amended returns, the employer must obtain signed statements from affected employees. These signed statements must indicate that the employee has not directly sought, and will not seek, a refund from the IRS for the employee's share of the over-withheld employment taxes.

Employers that have not already filed a 2014 fourth quarter Form 941 are allowed a
special correction method. Under this special rule, employers need not obtain signed statements from affected employees, and they can make adjustments for all quarters on their 2014 fourth quarter Form 941 instead of filing a 941-X for each quarter in 2014. The Notice has a detailed description of how to make adjustments to the 2014 fourth quarter Form 941.

If an employer chooses to not seek a refund for over-withheld employment taxes, then affected employees can seek a refund for their share of the over-withheld employment taxes on IRS Form 843.

**IRS Concludes that Some Debit Cards and Smart Cards Used for Transit are "Vouchers"**

With respect to transit reimbursements, employers are allowed to provide employees with cash reimbursements for transit passes only if the following three conditions are met:

- "Vouchers" are not readily available.
- The employee has already incurred the expense.
- The employer substantiates the expenses.

Vouchers take many forms but must be limited to an item that is itself a transit pass or can be used only to purchase a transit pass that is usable for local mass transit services.

**Lockton Comment:** In 2006, the IRS deferred issuing guidance on whether electronic payment methods or passes (e.g., debit cards) would be treated as vouchers. Electronic media were not widely used at the time, and the IRS wanted a larger data sample before requiring employers to use electronic media before providing cash reimbursements. The updated guidance discussed below reflects the reality that electronic media have become widely used.

A voucher is not readily available if the employer must pay a charge greater than one percent of the average annual value of the voucher or if certain inappropriate non-financial restrictions are imposed by the voucher provider (e.g., the minimum amount of the voucher purchase exceeds the monthly excludable amount discussed above).

Beginning Jan. 1, 2016, new IRS rules will treat electronic media used to purchase transit as vouchers, provided that the electronic media can be used only for qualifying mass transit. If the electronic media can be used to purchase goods or services other than qualifying mass transit, then the electronic media is not a voucher, and cash reimbursement may occur.

**Lockton Comment:** Electronic media can take many forms, but are frequently in the form of a debit card or smart card. Debit cards may be restricted to certain terminals or to merchants by an assigned merchant category code (MCC) similar to debit cards for health flexible spending account expenses. Smart cards are similar to debit cards but contain a memory chip that stores information that uniquely identifies the card and
The IRS’s updated guidance also provides for the following:

- A delivery charge for a transit pass purchased by employees online can be reimbursed tax free along with the transit pass itself.
- Employers providing cash reimbursements must require employees to certify that all expenses were incurred exclusively for purchase of qualifying mass transit. This certification must be obtained after the first month’s expenses are incurred and annually thereafter.
- The IRS reiterated that cash reimbursements can be provided only after employees have incurred transit expenses and that all expenses must be substantiated with receipts or statements showing the provider and amount.

**Lockton Comment:** The certification and substantiation process are both required. Substantiation proves that expenses were actually incurred, while the employee’s certification tells the employer that those expenses were in fact qualified mass transit purchases.

### New York City Passes Transit Benefit Mandate

Beginning in 2016, employers with 20 or more full-time employees in New York City are required to allow full-time employees in New York City to reduce their salaries on a pretax basis to pay for transit costs. Employers that reach the 20 full-time employee mark and then fall below that threshold will be required to maintain the salary reduction transit benefit for those employees who qualified for the benefit prior to the reduction in workforce.

**Lockton Comment:** Qualified parking is specifically excluded, so employers will be required to offer only transit or commuter benefits. While the ordinance is not absolutely clear, it appears that employers will be required to allow the maximum pretax salary reduction (e.g., $130 for 2015) permitted under federal tax rules. Additional guidance is expected prior to implementation.

The ordinance does not apply to government employers or employers that are exempt from federal, state and city payroll taxes. The transit benefit need not be extended to employees subject to a collective bargaining agreement, but employers with 20 or more full-time employees who are not subject to the collective bargaining agreement are still required to offer transit benefits for those full-time employees.

A full-time employee is one who averages 30 or more hours per week for the employer. Additional guidance is expected to provide details on what period of time the employee’s hours need to be reviewed to determine full-time status.
**Lockton Comment:** This definition of full-time employee sounds ominously familiar to the definition of full-time employee for purposes of federal health reform. Employers subject to the health reform law's employer mandate can use a relatively complicated look-back measurement method to determine whether health benefits need to be offered prospectively. See our Alert discussing those final rules. New York City may choose to offer some look-back method, but it is unclear whether the City will adopt the same rules for purposes of the transit benefit.

While the new ordinance goes into effect Jan. 1, 2016, it provides for a six-month grace period, so penalties will not begin until July 1, 2016. Penalties for a first violation will range from $100 to $250. If an employer corrects the violation within 90 days of being notified, then penalties will be waived. If correction (the steps for which have not been described) does not occur, penalties for the first violation will apply and an additional penalty will apply, equal to $250 for each 30-day period in which the employer continues to fail to offer the required benefits.

*Scott Behrens, J.D.*

*Compliance Services*

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