

**COMMENTS CONCERNING PROPOSED REGULATION ON QUALIFIED
TRANSPORTATION FRINGE BENEFITS UNDER INTERNAL REVENUE CODE
SECTION 132(F)**

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committee on Employee Benefits of the Section of Taxation (the "Committee"). Principal responsibility was exercised by Avery E. Neumark. Substantive contributions were made by Cheryl R. Hughes, Judith L. McMillin, and Carol A. Weiser. The Comments were reviewed by Taina E. Edlund, Committee Vice Chair and Diane J. Fuchs, Committee Chair. They were also reviewed by James R. Raborn of the Section's Committee on Government Submissions and by Stuart M. Lewis, Council Director for the Committee on Employee Benefits

Although many of the members of the section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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I. Executive Summary

The Committee commends the Treasury and Service on the issuance of the Notice of Proposed Rulemaking on Qualified Transportation Fringe Benefits published in the Federal Register on January 27, 2000, as proposed Treasury Regulation § 1.132-9 (the “Proposed Regulation”). The Proposed Regulation is helpful in clarifying a variety of issues pertaining to the administration of a transportation benefit program. We are especially pleased with Q/A-15 in which the Proposed Regulation addresses the treatment of unused compensation reduction amounts. We believe this provision will help to encourage greater use of qualified transportation programs and, consequently, help in reducing the overall congestion in metropolitan areas.

There are, however, certain provisions of the Proposed Regulation that would, in our opinion, benefit from clarifying or other changes. In the paragraphs that follow, we provide specific comments that address these concerns with the Proposed Regulation. We believe further changes need to be considered if the goal is to encourage employers to establish qualified transportation fringe benefit programs that include mass transit benefits. In particular, we believe that the incorporation of the following comments into the final regulation will further encourage employers to establish and continue these benefits. As a result, Code section 132(f) will have the effect of reducing metropolitan traffic, realizing Congress’s intent.

II. The “Readily Available Standard” for Cash Reimbursements

Internal Revenue Code section¹ 132(f)(1) allows for cash reimbursements for qualified transportation costs associated with commuter highway vehicles, qualified parking and mass transit passes. However, under section 132(f)(3), cash reimbursements for mass transit passes are allowed “only if a voucher or similar item that is exchangeable for a transit pass is not readily available for direct distribution by the employer to the employee.”

The Proposed Regulation follows the standard that was previously set forth in Notice 94-3 for determining when a transit pass is readily available. A transit pass is considered to be “readily available” “[when] an employer can obtain it -- (1) on terms no less favorable than those available to an individual employee; and (2) without incurring significant administrative cost.” The Proposed Regulation then creates a safe harbor for determining “significant administrative costs.” Under the safe harbor, costs are significant “if the average monthly administrative costs incurred by the employer for a voucher (disregarding delivery charges imposed by the fare media provider to the extent not in excess of \$15 per order) are more than 1 percent of the average monthly value of the vouchers for a system.” The Proposed Regulation further states

¹ Any reference to a section herein, refers to a section of the Internal Revenue Code, unless specifically stated otherwise.

that the determination of whether there exists significant administrative cost is made for each area in which the voucher is used.

We applaud Treasury's approach in creating a safe harbor rule for determining when vouchers will be required in lieu of cash reimbursement for transit passes. In the comments that follow, however, we recommend that the rules with regard to testing dates be clarified, that an additional safe harbor for multi-locational employers be added, and that certain other changes be made in the proposed safe harbor.

A. Annual Testing

In determining whether a transit voucher is "readily available" the employer must calculate whether the administrative costs of obtaining a voucher are "significant." Under Q/A-16, the "costs are treated as significant if the average *monthly* administrative costs incurred by the employer for a voucher . . . are more than 1 percent of the average *monthly* value of the vouchers for a system." (emphasis added) Moreover, under Q/A-9, the value of qualified transportation fringes is calculated on a *monthly* basis. Although the Proposed Regulation does not explicitly state when an employer is required to test for purposes of satisfying the "readily available" standard, it can be read as implying that testing should be conducted on a monthly basis, and we assume that is what was intended. In addition, the test speaks in terms of the monthly administrative charge actually "incurred" by the employer. See also the language in Q/A-16, which provides that costs are significant if the average monthly cost "incurred" by the employer in providing vouchers exceeds the safe harbor amount.

We believe the Proposed Regulation's inference that monthly testing is required based upon costs incurred is unworkable for two reasons. First, an employer that did not provide vouchers for a particular month based upon estimated employee transit pass usage and published transit pass rates in an area might well find itself in violation of the rule if its estimates proved to be incorrect or if the transit voucher vendor modified its rate schedule mid-month or at any time after the vendor's required pre-purchase date. In such a case, are employees to be taxed retroactively on the amount of elective deferrals or reimbursements received during that month? No employer, large or small, would relish explaining to its workforce why benefits that had been communicated as being tax-free have become retroactively taxable for a given month.

Second, the test speaks in terms of costs "incurred." If an employer believes that it is exempt from providing vouchers in a given area pursuant to the safe harbor, no additional costs are incurred. We do not believe that it was Treasury's intent to require all employers to shift month to month from a reimbursement to a voucher program because the employer literally cannot meet the "costs incurred" test. Thus, we would recommend that the rule require that the employer take into account the costs that "would have been incurred had a voucher program been in place."

Once the test is clarified in this manner, however, it becomes apparent that every employer implementing a qualified transportation program that provides for mass transit benefits must have administrative personnel (*e.g.*, a compliance officer) to monitor daily changes in the costs of mass transit vouchers (since the test is based on the *average* monthly costs) and calculate how that average cost compares to daily changes in employee elections for a month (*i.e.*, varying charges may be imposed for different denominations). The cost of administering such monthly tests is an excessive burden on employers of any size.

We believe that Treasury could simplify the testing in a manner that would not undermine the statutory intent, while simultaneously making the program more attractive to employers by alleviating excessive administrative burdens. Instead of monthly testing, we recommend that the final regulation be revised to state that the employer may test the “average monthly cost” associated with the voucher system on a yearly basis. A rule similar to “snapshot testing” in the qualified plan area would significantly enhance the viability of the program. Additionally, it may be prudent to require testing as the initial step of establishing a qualified transit program and again only in years, and with respect to locations, in which the fare media providers change their fees, there are significant changes in the employer’s demographics, or there are other similar changes in circumstances indicating a need for a new test. Thus, the employer will know if the vouchers are “readily available” before placing valuable resources into the development of a distribution system for transit passes. Moreover, after the program has been implemented, the employer will be able to devote fewer resources yearly to testing. Employers will be better able to predict the costs of establishing and maintaining a qualified transportation program and in turn will be more likely to implement and/or continue this valuable employee benefit. We believe that the above recommendations reflect a more workable standard for the testing period and, therefore, request that the final regulation include these clarifications.

B. Delivery and Administrative Charges

In determining whether cash reimbursements are allowed for a transit pass, under the Proposed Regulation, the employer must calculate the average monthly administrative costs incurred by the employer for a voucher disregarding any delivery charges up to \$15. In the example in Q/A-16(c), Company C imposes a 50-cent charge on each voucher delivered, as well as a \$15 charge for delivery. Because the cost of each voucher is \$65 and the total administrative cost is 50 cents (not including the \$15 delivery charge), the administrative cost is not significant. That is, the administrative cost in terms of a percentage of total cost equals .77 percent and does not exceed the 1 percent threshold. Delivery charges are not taken into account since they do not exceed the \$15 threshold.

This rule may disadvantage many smaller employers. Delivery charges can range from \$8.95 in Chicago to as high as \$15 for rush deliveries in Boston, San Francisco, Rhode Island, Louisville, Denver and Norfolk. For an employer with only 1 employee

participating in the transit program who elects the maximum benefit, a \$15 delivery charge causes the total employer cost to exceed 20 percent. Nonetheless, the Proposed Regulation would still require the employer to use the voucher system in this situation. Consequently, we recommend that the safe harbor calculation take into account all delivery charges imposed by the fare media provider, rather than only charges in excess of \$15.

The Proposed Regulation further specifies that the administrative costs taken into account under the “readily available” rule include only fees charged by the transit system or vendor of passes. We agree with other commentators that this interpretation of the term “administrative costs” is contrary to the commonly understood definition of the term, which would include any expenses an employer would incur in implementing a voucher program. We believe that it is reasonable to include within administrative costs both employers’ internal expenses and costs of any third party administrator or record keeper. The cost of developing and maintaining a distribution system for vouchers is particularly likely to be significant. One element that adds to the cost is the need to protect these bearer instruments from loss, destruction or theft. Furthermore, it would be unusual for an employer to have in place any mechanism similar to the arrangement that would be necessary for obtaining and distributing the vouchers. Many employers, however, have programs in effect for handling reimbursements of health care expenses or dependent care expenses under a cafeteria plan, and virtually all employers have established systems to reimburse employees for business expenses, such as business-related travel and meals. Thus, the expense of establishing a voucher program is likely to be greater because of the need to develop new systems, and these costs should be taken into account in determining whether the administrative costs of a voucher program are significant in applying the readily available standard under section 132(f)(3).

C. Dual Distribution Systems

Dual distribution systems may be required for all employers since the 1 percent safe harbor set forth in Q/A-16 is a calculation that may fluctuate from month to month. Employers that reimburse for mass transit passes must be prepared to switch immediately into a voucher distribution system whenever a transit voucher vendor reduces its surcharge or variations in employee elections result in a cost that falls below the safe harbor amount. Alternatively, an employer could (1) eliminate the program in areas during the period in which the safe harbor is not satisfied (which would be problematic from a human resources perspective), or (2) refuse to implement the program altogether. We are concerned that most employers will follow the latter approach.

Moreover, the Proposed Regulation fails to provide a strong incentive for employers with multiple locations to establish a qualified transportation fringe benefit program providing mass transit benefits. Consider an employer with locations in both New York City and Washington D.C. The Washington D.C. Metropolitan Area Transit Authority does not charge a fee above the face value of the voucher; thus, the vouchers are “readily available,” and the employer is required to provide vouchers to its Washington D.C. employees. On

the other hand, because a 4 percent surcharge is imposed in New York City, the employer's New York City employees may have the cost of their mass transit passes reimbursed with cash payments. Here the employer is required to maintain two entirely different administrative and accounting systems.

Further administrative obstacles result where, for example, after the employer implements the program and the regulation becomes final, the New York City fare media vendor, to continue receiving some benefit from the voucher system, reduces its cost of providing vouchers to an amount below 1 percent of the total voucher costs. Under the Proposed Regulation as drafted, it appears that the employer, having previously implemented a reimbursement arrangement, will be required to change its system overnight to handle voucher purchases and distributions. In certain locations, the conversion may be an impossibility as a result of prepurchase requirements that cannot be met in a timely fashion. This situation is further complicated when an employer has offices in numerous cities throughout the U.S.

Thus, each employer contemplating adopting a qualified transportation program, whether situated in multiple locations or in a single city, will as a practical matter be required to have a dual mechanism in place to handle both cash reimbursements and vouchers. We believe that this presents a major disincentive for employers to provide mass transit benefits. In our opinion, however, these issues would be adequately addressed by revising the basis or period for testing, as we have recommended above, permitting administrative costs to be taken into account in determining whether vouchers should be considered readily available, as is also recommended above, and including in the final regulations an additional safe harbor for employers with multiple locations, as discussed below.

D. Multi-Locational Employer Safe Harbor

Multi-locational employers will be particularly reluctant to offer qualified mass transit programs since substantial systems modifications may be required based solely upon price changes made by numerous unrelated vendors. Therefore, we recommend that a second safe harbor be considered that would ease the administrative burden for all employers with employees in more than one location. Under this safe harbor, after applying the 1 percent safe harbor rule to each location where the program is offered, if the employer would not be required to distribute vouchers to a significant number of its employees who participate in the mass transit program, then no location would be required to distribute vouchers. This safe harbor refines the 1 percent safe harbor by allowing an employer with multiple business locations to provide cash reimbursements in all locations if a significant percentage of its workforce participates in the mass transit program in any area where the average administrative costs that would be incurred by the employer for vouchers are more than 1 percent of the average monthly value of the vouchers for the system.

This new safe harbor would preserve the benefit for employees of multi-locational employers by protecting those programs from sudden price changes by mass transit vendors and changes in elections by employees. In addition, we believe that this would help to realign the qualified transportation regulation with Congress's intent to provide an incentive to employees to use mass transit. Specifically, employers with multiple locations would want to raise awareness of and participation in their mass transit programs so that their programs would meet the "significant number of participants" standard.

III. Substantiation

Another issue that is raised by the Proposed Regulation is the waiver of any substantiation requirement where the voucher system is used. Under Q/A-16(d), the Proposed Regulation addresses the proper methods for establishing a bona fide reimbursement arrangement. However, under Q/A-18, the Proposed Regulation states that "[t]here are no substantiation requirements if the employer distributes transit passes." We believe that the voucher system has serious potential for abuse. For example, if an employee receiving qualified transit passes from a salary reduction plan receives the maximum monthly benefit of \$65, he receives a \$65 bearer instrument with respect to which he has paid no federal income or employment taxes. The same employee is also entitled to a full benefit for qualified parking. If the employee drives his car to work and parks everyday, thus, not needing the transit pass, the employee could regularly sell the transit voucher at a discount (\$63) to another individual who uses mass transit. In this case, the employee has saved income and employment taxes on \$65/month (and is only out the \$2 discount), the employer has saved the employer portion of employment taxes, and the person on the street to whom the transit pass has been sold has received a discount that will be significant if he is able to repeat the transaction each month. Consequently, the only loser is the federal fisc. Moreover, there is no assurance that there has been any increase in mass transit usage, since the bearer instrument could be negotiated to any person on the street in need of a transit pass. Thus, we believe that the Proposed Regulation has created an incentive to employees to purchase mass transit vouchers on a pre-tax basis and establish a secondary market selling those vouchers at a discount. Because there is no enforcement mechanism to police this activity, tax dollars are lost forever.

In contrast, the cash reimbursement method established in Q/A-16(d) provides a method of substantiation giving the government greater assurance that there is less of a chance for abuse. Even though the Proposed Regulation provides that an employer may impose greater substantiation requirements if the employer distributes vouchers, the likelihood that any employer will want to increase its administrative burden is remote. We believe that the cash reimbursement system provides a safer method for the government to ensure that the qualified transportation fringe benefits rules are not abused. Accordingly, we commend the Treasury and Service for not imposing additional requirements beyond those statutorily necessary on the availability of the cash reimbursement method, but question whether additional safeguards may be appropriate in connection with the distribution of vouchers.

IV. Timing of Reimbursement for Parking

We also request clarification of the rules with respect to the timing of reimbursement for parking expenses. As stated above, Q/A-16(d) specifies the requirements for reimbursement arrangements, stating that employers must establish a bona fide arrangement to ascertain that employees “have, in fact, incurred expenses for transportation...” In addition, employers are required to establish reasonable procedures to ensure that amounts to be reimbursed were incurred for qualified transportation benefits. The three examples of reasonable procedures in the proposal each describe a situation in which an employee submits a request for reimbursement after the end of the month in which the employee has used either parking or a transit pass. In many areas, however, if an employee wishes to secure a parking space in a particular lot or garage on or near the employer’s premises, the employee must pay for an entire month of parking in advance of the month. In other areas, although an employee may not be compelled to pay for parking in advance to secure a space, there is a significant difference in the cost of parking if it is paid for on a daily basis, rather than monthly in advance. Generally, where an employee pays monthly in advance for parking, the employee will not be entitled to a refund if he is unable to use the parking space for the entire month.

Where an employee pays in advance for nonrefundable parking on a monthly or other periodic basis, we believe the employee has incurred the parking expense and should be eligible for reimbursement for the entire period, even if mid-way through the month the employee finds he is unable to use the parking for the balance of the period. Specifically, we believe that a reasonable reimbursement procedure should allow the employee to present a receipt for parking in advance of the period to which the payment applies and certify to his employer that the employee (1) intends to use the parking and (2) is not entitled to a refund if he does not use the parking for the entire period. Although, we think that the Proposed Regulation can be read to permit this type of reimbursement, we request that the final regulation include an example illustrating such a procedure or otherwise clarify the rules regarding timing of reimbursements to specify that such a procedure is permissible.

V. Effective Date and Transition Relief

The Proposed Regulation provides no effective date, nor any provision indicating whether employers may rely on the Proposed Regulation as a good faith interpretation of the law. In the absence of specific regulatory guidance prior to the Proposed Regulation, many employers across the country have implemented and administered salary reduction transportation plans in good faith by making reasonable interpretation of the statutory requirements under section 132(f) and IRS Notice 94-3, but have used rules that would be prohibited under the Proposed Regulation.

We request that the final regulation in this area take this good faith compliance effort into consideration and that any affirmative compliance requirements for salary reduction

transportation benefit arrangements apply on a prospective basis. We further request that the final regulation take into account the difficulties employers will have in implementing any new requirements for salary reduction transportation benefit programs, and thus the time needed to modify existing programs, in determining an appropriate effective date for guidance in this area. We request retroactive relief where appropriate to reflect the effective date of the changes to section 132(f). We also request transitional relief from any income or employment tax consequences for the employers (and their employees) who implemented transportation benefit plans prior to the issuance of the final regulation. Accordingly, we recommend that the final regulation provide that the final rules take effect as of the first day of the calendar year commencing at least twelve months after the date the final regulation is issued.

VI. Transportation Fringe Benefits Impact on Retirement Benefits

The Proposed Regulation does not provide the guidance needed as to whether a qualified transportation fringe benefit falls under the safe harbor definitions of compensation for qualified plans. In addition, section 132(f) salary reduction contributions may presently be interpreted as reducing the employee's compensation for purposes of the section 415 limit. The issue stems from the present wording of section 415(c)(3), which does not cross-reference section 132(f), unlike the inclusion in section 415(c)(3)(D) of the rule providing that salary reduction contributions under sections 401(k), 403(b), or 125 plans are to be added back to compensation under section 415(c). The lack of cross-referencing also affects the definition of highly compensated employee within section 414(q) and the nondiscrimination testing of compensation under section 414(s). Thus, as a result of any salary reduction for transportation fringe benefits, the amount of an employee's compensation will be correspondingly decreased for purposes of calculating retirement benefits or, at a minimum, for testing compliance with respect to such benefits.

Congress did not intend this outcome. The Joint Committee's General Explanation of Tax Legislation Enacted in 1998 provides direct guidance that salary reduction amounts used to provide transportation fringe benefits should be treated for pension purposes in the same manner as other salary reduction contributions. Specifically, the Committee, stated

“it is intended that such amounts be included for purposes of applying the limits on contributions and benefits [sections 415 and 401(a)(17)], and that an employer may elect whether or not to include such amounts in compensation for nondiscrimination testing . . . It is expected that the Secretary, prescribing rules regarding the alternative definition of compensation, will treat salary reduction amounts under this provision the *same* as other salary reduction contributions.” (emphasis added)

Moreover, legislation has been introduced into Congress (H.R. 1102, § 515) and (S. 741 § 609) whereby section 415(c)(3)(D) adds back to “compensation” salary reduction amounts used for qualified transportation fringe benefits under section 132(f). Passage of these bills will satisfy

Congress's intent to treat salary reduction transportation fringe benefits in the same fashion as salary reduction contributions to plans established under sections 401(k), 403(b), and 125.

Nonetheless, based on the legislative history to section 132(f) cited above, we believe that Treasury has the authority to issue regulations including compensation reductions under section 132(f) as compensation for purposes of section 415 even absent enactment of a change in section 415 by Congress. Consequently, we respectfully recommend that the final regulation make the following changes regarding the interplay between sections 132(f) and 415:

1. The IRS and Treasury should revise the definition of compensation under Treas. Reg. § 1.415-2(d) to exclude salary reduction contributions section 132(f).
2. These changes should be effective retroactively.

