

in this issue:

DECEMBER 2006

The IRS issued Revenue Ruling 2006-57, which provides employers guidance on the use of smart cards and debit cards to provide qualified transportation fringe benefits to employees on a tax-exempt basis.

Littler Mendelson is the largest law firm in the United States devoted exclusively to representing management in employment and labor law matters.

Employment Taxes

A Littler Mendelson Newsletter
specifically for the Employment Taxes

IRS Provides Guidance For Employers That Use Smart Cards And Debit Cards To Provide Transportation Fringe Benefits To Employees

By GJ Stillson MacDonnell and William Hays Weissman

The IRS has just released Revenue Ruling 2006-57, which provides employers guidance on the use of smart cards and debit cards to provide qualified transportation fringe benefits. The Internal Revenue Code (Code) excludes from both gross income and "wages" certain qualified transportation fringe benefits. Thus, such amounts are not subject to income tax withholding or payroll taxes (FICA and FUTA) and are a good way for employers to provide additional compensation to employees without the associated tax costs.

The Requirements for Providing Tax-Exempt Transportation Fringe Benefits

The Code allows employers to provide a qualified transportation fringe benefit that is excluded from gross income. Code section 132(f)(1) defines the term "qualified transportation fringe" to mean (1) transportation in a commuter highway vehicle between home and work, (2) any transit pass, and (3) qualified parking.

Code section 132(f)(5)(A) defines a "transit pass" as any pass, token, fare card, voucher or similar item entitling a person to transportation (or transportation at a reduced price) if such transportation is on mass transit facilities or is provided by any person in the business of transporting persons for compensation or hire in a commuter highway vehicle. An employer may provide the employee with a cash reimbursement for a travel voucher. However, a qualified transportation fringe includes a cash reimbursement by an employer to an employee for a transit pass

only if a voucher or similar item that may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee. Reimbursement must be made pursuant to a bona fide reimbursement plan.

While an employer may provide any amount of transportation fringe benefit, the amount that may be excluded from gross income and wages is limited to \$105 per month for the aggregate of transportation in a commuter highway vehicle and transit passes, and \$205 per month for qualified parking, for 2006, and increases to \$110 for transit passes and \$215 for parking for 2007.

Guidance Provided in the Revenue Procedure

The Revenue Ruling contains four factual situations:

In Situation 1 the employer provides its employees smart cards in an amount not exceeding \$105 in 2006 that may be used by employers in the metropolitan area served by the local transit system as a mechanism to provide fare media for the transit system to employees. The smart cards are plastic cards containing a memory chip that stores certain information including the serial number of the card and the value of the fare media stored on the card. The amount stored as fare media on the smart card is not authorized to be used to purchase anything other than fare media for the transit system.

The IRS held that the value of the smart cards used to provide transit pass benefits in Situation 1 is excluded from gross income and from wages for employment tax purposes.

In Situation 2 the employer provides its

employees debit cards provided by a third party in an amount not exceeding \$105 in 2006. The debit cards are restricted for use only at merchant terminals at points of sale at which only fare media for the local transit system is sold. The employer makes monthly payments to the third party on behalf of its employees who participate in the transportation benefit program, who then electronically allocates to each employee's terminal-restricted debit card as instructed by the employer. The employer does not require its employees to substantiate their use of the debit cards.

The IRS held that the value of the smart cards used to provide transit pass benefits in Situation 2 is excluded from gross income and from wages for employment tax purposes.

In Situation 3 the employer provides its employees debit cards in an amount not exceeding \$105 for 2006. The debit cards restrict the use of the debit cards to merchants that have been assigned a merchant category code (MCC) indicating that the merchant sells fare media. The cards are restricted for use at merchants that have been assigned MCCs indicating the merchant sells fare media for some or all of the following categories: local and suburban commuter passenger transport; passenger railway; bus lines, excluding charters and tours; and transportation service (not elsewhere classified). The merchant may or may not sell other merchandise. The MCCs were developed by a debit/credit card network.

For the first month an employee participates in the transportation benefit program, the employee pays for fare media with after-tax amounts. The employee then substantiates to the employer the amount of fare media expenses incurred during the month following reasonable substantiation procedures, and the employer provides funds that are placed on the debit cards for the employees. For subsequent months the employer reimburses the expenses by receiving periodic statements providing information on the use of each debit card, which include information on the identity of the merchants at which the debit card was used, and the date and amount of the debit card transactions. The employer does not also require any other substantiation, except that annually it requires each employee to certify that the debit card was used only to purchase

fare media.

In Situation 3 the IRS held that the debit cards do not qualify as a transit pass because they can be used to purchase items other than transportation fringe benefits. However, because the employer has a bona fide cash reimbursement plan, which includes verifying that the funds are used only to purchase transportation benefits, and an annual certification, the value of the transit pass benefits provided in Situation 3 is excluded from gross income and from wages for employment tax purposes.

In Situation 4 the facts are the same as in Situation 3, except in the following respects: the employer provides employees with MCC-restricted debit cards as soon as they begin work. Prior to using the MCC-restricted debit cards, the employees certify that the card will be used only to purchase transit passes. In addition, written on each debit card is the statement that the card is to be used only for transit passes, and, by using the card, the employee certifies that the card is being used only to purchase transit passes. At no time do the employees substantiate to the employer the amount of fare media expenses that have been incurred.

The IRS held that the value of the debit cards in Situation 4 is not excluded from gross income and are wages for employment tax purposes because the debit cards, similar to Situation 3, do not qualify as a transit pass and there is no bona fide reimbursement plan. A certification that the amount will only be used for transit passes is not sufficient to meet the substantiation requirement.

While the effective date of Revenue Ruling 2006-57 is January 1, 2008, employers may rely upon its guidance for transactions occurring before that date. The IRS also indicated that it will continue to study the use of electronic smart cards and debit cards and provide additional guidance in the future.

Employers should review their own transportation fringe benefit policies and determine whether they comply with the Code and Treasury Regulations. If employers are not using smart cards or debit cards, they may want to review those options to determine if they make sense both from a cost reduction and administrative burden perspective. Employers that desire to use smart cards or debit cards

should ensure that their policies are compliant with Revenue Ruling 2006-57.

GJ Stillson MacDonnell is a shareholder and chair of Littler's Employment Taxes Practice Group and William Hays Weissman is an associate in Littler's Employment Taxes Practice Group. If you would like further information, please contact your Littler attorney at 1.888.Littler, info@littler.com, Ms. MacDonnell at gjmacdonnell@littler.com or Mr. Weissman at wweissman@littler.com.
