Implementation of Rev. Rul. 2006-57—Issues for Public Comment

Notice 2012-38

PURPOSE

This Notice requests public comments on issues associated with Revenue Ruling 2006-57, 2006-2 C.B. 911, which became effective on January 1, 2012. Rev. Rul. 2006-57 provides guidance on the use of smartcards, debit or credit cards, or other electronic media to provide qualified transportation fringes under sections 132(a)(5) and (f) of the Internal Revenue Code (the Code). The Treasury Department and the Internal Revenue Service have become aware of changes in technology that may give rise to the need for additional guidance on the use of electronic media to provide transit benefits.

BACKGROUND

Section 132(a)(5) of the Code provides that any fringe benefit that is a qualified transportation fringe is excluded from gross income. Section 132(f)(1) provides that the term "qualified transportation fringe" means, when provided by an employer to an employee, (1) transportation in a commuter highway vehicle between home and work, (2) any transit pass, (3) qualified parking, or (4) any qualified bicycle commuting reimbursement.

Section 132(f)(5)(A) provides that a transit pass is any pass, token, farecard, 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.

Section 132(f)(3) of the Code generally allows employers to use cash reimbursement arrangements to provide employees with qualified transportation fringe benefits. This section, however, prohibits use of such arrangements to provide transit benefits "if a voucher or similar item which may be exchanged only for a transit pass" is "readily available." Section 1.132-9, Q/A-16(b) of the Regulations specifies that a voucher or similar item is not readily available if the entity providing it imposes restrictions that effectively prevent the employer from obtaining vouchers appropriate for distribution to employees. Examples of such restrictions include:

(1) Excessive fare media charges: The term "fare media charges" refers to extra fees that the voucher-provider requires employers to incur to furnish employees with vouchers. Such fees are excessive if the average annual fare media charges that the employer incurs to provide its employees with transit benefits via vouchers are more than one percent of the average annual value of the vouchers for a transit system.

(2) Advance purchase requirements: A voucher-provider imposes an excessive advance purchase requirement if it "does not offer vouchers at regular intervals or fails to provide the voucher within a reasonable period after receiving payment for the voucher." The regulations clarify that a requirement that employers purchase vouchers only once per year is an excessive advance purchase requirement, but a requirement that an employer purchase vouchers on a monthly basis is not.

(3) Purchase quantity requirements: A voucher is not readily available if the voucher-provider requires the employer to purchase vouchers in quantities that are not reasonably appropriate considering the number of employees who use mass transit.

(4) Limitations on denominations of available vouchers: A voucher is not readily available if the voucher-provider requires the employer to purchase vouchers in denominations that are not appropriate for distribution to the employer's employees.

Section 1.132-9, Q/A-16 of the Regulations provides that a qualified transportation fringe includes cash reimbursement for transit passes made under a bona fide reimbursement arrangement that meets substantiation requirements specified in the regulations. In discussing the application of Section 132(f) of the Code to reimbursements, Section 1.132-9, Q/A-16(a) of the Regulations provides that a payment made before the date an expense has been incurred or paid is not a reimbursement; nor does a bona fide reimbursement arrangement include an arrangement that is dependent solely upon an employee certifying in advance that the employee will incur expenses at some future date. Employers must implement reasonable procedures to ensure that employees have incurred expenses for transit passes in an amount equal to the reimbursement. What constitutes a reasonable procedure depends on the facts and circumstances of a particular arrangement. The Regulations further require employees to provide any such substantiation within a "reasonable period of time."

Rev. Rul. 2006-57 provides guidance on the use of smartcards, debit or credit cards, or other electronic media to provide employees with transportation fringes. The

ruling was originally scheduled to become effective January 1, 2008. However, Treasury and the IRS delayed the effective date of the ruling several times in order to give transit systems additional time to modify their technology to comply with the requirements set forth in Revenue Ruling 2006-57, most recently in Notice 2010-94, 2010-52 I.R.B. 927, which delayed the effective date until January 1, 2012. There have been no subsequent notices delaying the effective date of the revenue ruling. The revenue ruling is therefore now effective.

The revenue ruling includes four situations that illustrate the tax treatment of arrangements under which employers use electronic media to provide employees with transportation benefits.

Employers in the first situation distribute “smartcards” to their employees. Employees use the fare media value that is stored on these cards to pay for transportation on the local transit system. The fare media value stored on the cards is useable only to pay for transportation on the local transit system. The revenue ruling therefore concludes that the smartcards qualify as transit system vouchers under section 1.132-9(b) of the Regulations. The value of the fare media stored on the smartcards, up to the applicable monthly limit, is excludable from an employee’s gross income as a qualified transportation benefit. Under section 1.132-9(b) Q/A-18, employees are not required to substantiate their use of the smartcards.

In the second situation, employers furnish employees with debit cards. These 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. Employers make monthly payments to the debit card provider, which the debit card provider then allocates to each

employee's card. The revenue ruling concludes that these terminal-restricted debit cards qualify as transit system vouchers under section 1.132-9(b) because, similar to the smartcards in the first situation, they can be used only to purchase fare media on the local transit system. Amounts stored on these debit cards are excludable from employee's gross incomes to the extent that they do not exceed the applicable monthly limit and employees are not required to substantiate their use of the debit cards.

The revenue ruling's third situation depicts an arrangement under which employers provide employees with debit cards that employees can use to purchase transit benefits under circumstances in which vouchers or similar items exchangeable only for transit passes are not readily available. These debit cards are restricted for use only at merchants that have been assigned a merchant category code (MCC-restricted) indicating that the merchants sell fare media for the local transit system. The merchants may or may not sell other merchandise. The revenue ruling concludes that these debit cards do not qualify as transit system vouchers under section 1.132-9(b) because there is nothing in the debit card technology that prevents the use of the cards to purchase items other than fare media for the local transit system. However, because transit passes are not readily available to the employers in these circumstances, the employers are permitted to distribute transit benefits via bona fide cash reimbursement arrangements. The revenue ruling concludes that the facts of this third situation result in a bona fide cash reimbursement arrangement because employees are required to pay for fare media with after-tax amounts during their first month of participation in the transportation benefit program, the employees must substantiate the amount of their monthly expenses to the employers, and the employers provide funds that the debit

card provider allocates to each debit card in an amount that does not exceed the lesser of the applicable monthly limit or the amount of the employee's substantiated fare media expenses for the prior month.

The facts in the fourth situation are the same as those in the third situation, except that the employer provides employees with the MCC-restricted debit cards before they begin work. Before using the MCC-restricted debit cards, employees must certify that the card will be used only to purchase transit passes. Further, written on each card is a statement that the card is to be used only for transit passes and, by using the card, the employees certify that the card is being used only to purchase transit passes. The revenue ruling concludes that the arrangement in the fourth situation does not meet the requirements of a bona fide cash reimbursement arrangement because it provides for advances rather than reimbursements and because it relies solely on employee certifications provided before expenses are incurred. Those certifications, standing alone, do not provide the substantiation of expenses incurred necessary for there to be a bona fide reimbursement arrangement.

At the time Rev. Rul. 2006-57 was issued, the Treasury Department and the Internal Revenue Service (IRS) lacked sufficient factual context to develop guidance regarding whether terminal-restricted debit cards were "readily available". The revenue ruling indicates that the IRS intends "to issue guidance clarifying under what situations the cards are considered to be readily available and thus preclude cash reimbursement for transit benefits." In the interim, employers may use bona fide cash reimbursement arrangements when the only available voucher or similar item is a terminal-restricted debit card.

REQUESTS FOR COMMENT

Treasury and the IRS have become aware that changes in fare media and in transit benefit administration may have created the need for guidance in addition to the guidance issued concerning the specific situations described in Rev. Rul. 2006-57. Developments in technology, an increase in the number of transit systems and third parties providing electronic media for transit use, and the trend away from use of paper fare media provide a basis for concluding that the four situations described in Rev. Rul. 2006-57 may not cover the full range of available electronic media for providing fare media.

Treasury and the IRS request comments on how electronic media may meet the statutory requirements under section 132(f) for providing transit benefits, either as vouchers or transit passes or through bona fide cash reimbursement arrangements in a manner other than those described in situations one through four in Rev. Rul. 2006-57. Also, Treasury and the IRS request comments on the availability of terminal-restricted cards and any other electronic media qualifying as vouchers or transit passes for purposes of determining whether such items are readily available and, therefore, cash reimbursement arrangements for providing transit benefits should be prohibited. Finally, Treasury and the IRS request comments on challenges employers encounter in transitioning from paper transit passes or vouchers to electronic media that qualify as vouchers or transit passes, or from cash reimbursement arrangements to electronic media qualifying as transit passes or vouchers.

1. Electronic Media other than those described in Revenue Ruling 2006-57

Revenue Ruling 2006-57 distinguishes the tax-treatment of terminal-restricted debit cards and MCC-restricted debit cards under the facts described in the situations. Specifically, the revenue ruling concludes that under the facts described in those situations. a terminal-restricted debit card qualifies as a transit pass under section 132(f) of the Code, while MCC-restricted debit cards do not qualify as transit passes because the holders may be able use the MCC-restricted debit cards to purchase items other than fare media. Treasury and the IRS have become aware of technological advances that may enable providers of MCC-restricted debit cards to limit the use of these cards to such an extent that it is almost, if not entirely, impossible to use the cards to purchase any items other than fare media. In light of these technological advances, Treasury and the IRS request comments on circumstances in which the use of MCC-restricted debit cards is sufficiently circumscribed so that the cards qualify as transit passes or vouchers providing transit benefits.

2. Definition of "readily available"

As discussed in the Background section, employers may use bona fide cash reimbursement arrangements to provide employees with qualified transportation fringe benefits only if vouchers or similar items are not readily available. The regulations state that a voucher or similar item is not readily available if the entity providing the item imposes restrictions that effectively prevent employers from obtaining vouchers appropriate for distribution to employees. Revenue Ruling 2006-57 did not provide guidance on what constitutes "readily available" in the context of terminal-restricted debit cards, but the revenue ruling indicated that this issue will be addressed in future guidance. The IRS requests comments on whether terminal-restricted debit cards are

widely used, the availability of terminal-restricted debit cards in areas where paper vouchers are no longer accepted by the local transit system, the ease with which employers can acquire terminal-restricted debit cards to distribute transit benefits, and any issues that employers and/or employees are encountering in connection with the use of such cards.

3. Transitions from paper transit system vouchers to electronic vouchers or to bona fide cash reimbursement systems.

Treasury and the IRS have become aware of issues arising in locations in which transit systems no longer accept paper transit passes. Some benefit providers in these locations that previously provided transit benefits via paper vouchers now plan to provide benefits via electronic media that qualify as transit passes or vouchers, or via bona fide cash reimbursement arrangements because no other transit passes or vouchers are readily available for use on the transit systems. The IRS requests administrators of, and participants in, such arrangements to provide comments concerning any issues that have arisen related to the transition from paper vouchers to other methodologies for providing transportation fringe benefits. For example, employers transitioning from paper transit passes to cash reimbursement arrangements may have questions regarding how to comply with the requirement in section 1.132-9, Q/A-16 that employees incur expenses prior to the date employers make payments as they move from an in-kind arrangement, which does not have such a requirement regarding the timing of expenses, to a cash reimbursement arrangement.

4. Application of bona fide reimbursement arrangement requirements in context of electronic media.

Treasury and the IRS also requests comments concerning the circumstances under which the provision of transit benefits via electronic media constitutes a bona fide reimbursement arrangement. For example, the IRS has become aware of arrangements under which employers load funds onto electronic media at the beginning of each month after receiving an employee certification of expected transit expenses and then utilize one or both of the following: (1) true-up mechanisms under which employers periodically review statements detailing employees' transactions and require employees to repay the costs of any "unauthorized" transactions, or (2) sweep-away mechanisms under which employers delete any unused amounts from employees' electronic media at the end of each month. The IRS requests comments concerning whether arrangements under which employers credit employees' electronic media with amounts before the employees actually incur transit expenses may qualify as bona fide cash reimbursement arrangements through use of one or both of these safeguards and if the employee provides reasonable substantiation of the expenses incurred within the meaning of Section 1.132-9, Q/A-16(c). The IRS also requests comments concerning any other similar safeguards that should enable such up-front crediting of employees' electronic media to qualify as bona fide cash reimbursement arrangements.

REQUEST FOR COMMENTS

The IRS requests comments on the issues described above. Comments should be submitted in writing on or before August 27, 2012. All Comments will be available for public inspection and copying. Comments may be submitted in one of three ways:

1. By mail to CC:PA:LPD:PR (Notice 2012-38), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

2. Electronically to Notice.Comments@irscounsel.treas.gov. Please include “Notice 2012-38” in the subject line of any electronic communications.

3. By hand-delivery Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2012-38), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC 20224.

DRAFTING INFORMATION

The principal author of this announcement is Syd Gernstein of the Employment Tax 2, Tax Exempt and Government Entities Division. For further information regarding this announcement, contact Syd Gernstein or Jean Casey at (202) 622-6040 (not a toll-free call).