

Compliance Corner: When Can Employers Reimburse Transit Pass Expenses? The IRS “Readily Available” Test

CONEXIS

Under applicable tax law, employers may provide tax-free mass transit benefits to their employees under a qualified mass transit program. However, the tax rules generally require that such programs distribute mass transit passes to employees rather than reimburse employees under a “reimbursement account arrangement” for the mass transit expenses employees incur. An exception to this rule allows for “mass transit reimbursement arrangements” where the mass transit voucher (or pass) is not “readily available” for direct distribution by the employer to employees (Treas. Reg. 1.132-9 Q/A 16). Thus, the fundamental question that each employer must address is whether mass transit vouchers are readily available in each geographic area where employees participate. If the vouchers are readily available in a geographic area, mass transit pass expenses incurred by employees cannot be reimbursed.

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Marking Milestones: Age-Banded Approach a More Accurate Portrayal of Retirement Planning

Employee Benefit News
Somnath Basu, Ph.D.

A convergence of mega trends will forever change retirement planning and raise its importance in the pantheon of employee benefits. Chief among them: longer life expectancy, medical advances, healthier lifestyles and mounting concern about years of abysmally low savings rates.

What this means in practical terms for future retirees is that employers, service providers and financial advisors must plot a more accurate and thoughtful course to planning for retirement that pursues an “age-banded” approach - understanding that individuals undergo various lifestyle changes during retirement that last for finite, or age-banded, periods.

For example, people spend more time and money on leisurely activities early on in retirement, while healthcare needs dominate the latter years. Further, costs associated with

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Under applicable tax regulations, a voucher¹ is readily available for direct distribution by an employer to employees (which means that a reimbursement arrangement is *not allowed*) if and only if:

- 1) The employer can obtain vouchers from a “voucher provider” without incurring “significant administrative costs”. The regulations indicate that the employer incurs significant administrative costs (and thus the vouchers are not readily available) if the fare media charges that the employer reasonably expects to incur for transit system vouchers purchased from the voucher provider exceed 1% of the average annual value of the vouchers; and
- 2) The voucher provider does not impose non-financial restrictions that effectively prevent the vouchers from being readily available.

We have provided below a checklist for determining if vouchers sold by voucher providers in a particular area are readily available. This checklist will assist employers with that determination. Each employer should consult with its own tax advisor or legal counsel to determine ultimately if vouchers are readily available. To provide further assistance, we have attached a flowchart at the end of this summary that provides a high level overview of the discussion below.

Step 1: Is There a Voucher Provider Available?

A voucher provider is a company (including a mass transit authority) that is in the business of selling transit system vouchers to employers. A voucher provider is not a third party administrator who administers the program for the employer using vouchers that could be purchased by the employer directly.

If there is not a voucher provider available in an area, vouchers are not readily available and the plan may provide cash reimbursement for a participant’s transit pass expenses.

If there is a voucher provider available, then proceed to Step 2.

Step 2: Does the Employer Incur Significant Administrative Costs by Purchasing the Voucher from the Voucher Provider?

You must complete the three items below to determine if the employer’s administrative cost associated with purchasing vouchers is significant.

A: Determine the Employer’s Average Cost to Purchase the Vouchers

Only Costs Imposed by the Voucher Provider Can Be Considered: The employer’s cost equals the

1 A voucher is an instrument that may be purchased by employers by a voucher provider that is accepted by one or more mass transit operators in an area as fare media or in exchange for fare media.

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external costs that the employer reasonably expects to incur (above and beyond the value of the voucher) by purchasing the vouchers from the voucher provider, excluding any reasonable and customary delivery charges imposed by the voucher provider of \$15 or less. An external cost that would be considered in determining the employer’s cost would be an additional charge imposed *by the voucher* provider in order to recover administrative costs and any delivery fees over and above the \$15 reasonable and customary delivery charge for that area. Thus the following reasonably foreseeable costs are NOT considered in the determination:

- External delivery charges of \$15 or less
- Internal storage costs
- Internal distribution costs
- Internal accounting costs
- Internal reconciliation costs
- External fees imposed by a third party intermediary other than the fare media provider (e.g. a broker or third party administrator).

How do You Determine the Average Charge for Each Voucher Provider?

The regulations provide no guidance on this issue. For example, if the service charge varies depending upon denomination of the voucher’s

offered should an “average percentage” charge be taken or should the charge applicable to the average voucher amount used by the specific employer be used. For example, if 100 employees participate in an employer’s program, and 33 are expected to use vouchers of \$15 in denomination (with a 23 cent charge), 33 are expected to use vouchers of \$25 in denomination (with a 25 cent charge), and 33 are expected to use vouchers of \$35 in denomination (with a 28 cent charge) – would the average charge for this employer be 25 cents or 25.3 cents? How should this “average cost” determination be made if the service charge is assessed with regard to each voucher order (i.e., a batch of different denomination vouchers) or a flat rate for each voucher purchased (regardless of denomination)? This determination could affect whether the 1% threshold is satisfied. Given the lack of IRS guidance in this area, employers will need to consult with their legal and tax advisors to make this determination. It seems that there are several possible reasonable interpretations.

Special Rules Where There are Multiple Voucher Providers

The regulations provide special rules for determining the average annual charge for voucher providers where there are multiple voucher providers:

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- (a) *More than one transit system voucher is available for direct distribution:* [For example, Company B and Company C sell mass transit system vouchers that are accepted by most if not all of the mass transit systems in the area. By way of another example, the bus line accepts its own mass transit card only and the rail line accepts its own mass transit card and/or Company B’s vouchers, but either mode of mass transit will satisfy the needs of the individual employees]. In this situation, the employer must consider the fees imposed for the *lowest cost monthly voucher*.
- (b) *Transit system vouchers for multiple transit systems are needed to meet the transit needs of employees:* [This is the same situation described in subsection (a) except that under this situation, employees must use multiple modes of mass transit to satisfy their needs (e.g. An employee who works in New York but lives in New Jersey must ride the subway to get to work, but the employee must first ride the rail line to get to the subway line).] If vouchers for multiple transit systems in an area are needed to meet the needs of individual employees in the area, the employer may average the costs applied to each transit system.

B. Determine the Annual Value of Vouchers that will be Purchased

The employer must determine the average annual face value of the vouchers (exclusive of costs) it will purchase from the voucher provider. If there are multiple voucher providers, calculate the average annual value of the vouchers it will purchase from *each* voucher provider (this is necessary because, as noted in step B below, the lowest cost voucher provider may be considered unless multiple vouchers are required for transit). Based on an example in the regulations (Treas. Reg. 1.132-9 Q/A 16(b)(7)), it appears that the average annual value of the vouchers can be determined based on the denominations expected to be used *by the employer* – not the average of all denominations offered by the voucher provider. Thus, for example, if 100 employees participate in an employer’s program, and 33 are expected to use vouchers of \$15 in denomination, 33 are expected to use vouchers of \$25 in denomination, and 33 are expected to use vouchers of \$35 in denomination – the average for this employer would be \$25 *even if* higher denomination vouchers are offered by the voucher provider.

Average Annual Value: _____

Employer’s Average External Costs:

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C: Is A More Than 1% of B?

The employer has incurred significant administrative costs such that vouchers are not readily available if the amount determined in A is MORE than 1% of B. For example, assume that only one mass transit system voucher is available for direct distribution and the employer determines that the average annual value of the vouchers is \$55. The voucher provider imposes a \$.50 cent charge on each voucher in order to cover its administrative costs and also imposes an \$8 delivery fee, which is reasonable and customary in the area. In this example, the administrative cost is less than 1% of the average annual value of the voucher provider (\$.50/\$55), which is less than 1%. This means vouchers are readily available (remember, the delivery charge must be excluded from the calculation because it is reasonable and customary).

Amount in A _____ divided by amount in B _____ = _____%

If the percentage is greater than 1%, then the vouchers are not readily available and employees may be reimbursed in cash for transit pass expenses.

If the percentage is equal to or less than 1%, then vouchers are readily available. Proceed to step 3.

Step 3: Does the Voucher Provider Impose Non-Financial Restrictions on the Purchase of Vouchers that Effectively Prevent Them from Being Readily Available?

The regulations list the following three examples of non-financial restrictions that may cause the vouchers to not be readily available regardless of the outcome of the 1% test in Step 2 above. These examples are not exhaustive. If a voucher provider places any other non-financial restrictions on the purchase of vouchers, the client should consult with legal counsel as to whether such a restriction would result in the voucher provider not being readily available.

A. Are there Unreasonable Advance Purchase Requirements?

Advance purchase requirements imposed by the voucher provider will be unreasonable and thus cause a voucher to not be readily available if (i) the voucher cannot be purchased at “regular intervals” (e.g. monthly intervals) or (ii) the voucher provider fails to provide the vouchers within a reasonable period of time after receiving payment for the voucher. [WARNING: The regulations do not provide the scope of what constitutes “regular intervals” other than monthly and they do not indicate what constitutes “delivery within a reasonable period

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of time”. By way of example, the regulations indicate that annual intervals do not constitute a “regular interval”, but that is the extent of the clarification provided. Presumably, something more than monthly and less than annual would not constitute a regular interval such that the vouchers are readily available, but there is no guidance. Clients should consult with their tax advisor or legal counsel to determine what is a regular interval.]

If it is determined that the voucher provider imposes unreasonable advance purchase requirements (i.e. vouchers cannot be purchased from the voucher provider in regular intervals or the voucher provider does not deliver the vouchers within a reasonable time after receiving payment), the vouchers are not readily available and the plan may provide for cash reimbursement of transit pass expenses regardless of the outcome of the 1% test in Step 2 above.

If it is determined that there are no unreasonable advance purchase requirements, (i.e. vouchers can be purchased from the voucher provider in regular intervals or the vouchers are delivered within a reasonable time after receiving payment), then proceed to B below.

B. Are there Unreasonable Purchase Quantity Requirements?

A voucher provider imposes unreasonable purchase quantity requirements if the voucher provider does not offer quantities of vouchers that are reasonably appropriate to the number of the employer’s employees who use mass transit systems. [WARNING: The regulations do not indicate exactly what is “reasonably appropriate.” The regulations do indicate, by way of example that a requirement for an employer with 200 employees to purchase 1,000 vouchers would be unreasonable. Clients should consult with their tax advisor or legal counsel to determine if a purchase quantity requirement imposed by a voucher provider is unreasonable.]

If it is determined that a purchase quantity requirement imposed by a voucher provider is unreasonable, the vouchers are not readily available and the plan may provide for cash reimbursement of transit pass expenses regardless of the outcome of the 1% test in Step 2 above.

If it is determined that a purchase quantity requirement imposed by a voucher provider is reasonable, the vouchers are readily available. Proceed to C below.

C. Are there Inappropriate Limitations on Denominations that are Available for Purchase?

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The denominations available for purchase from the provider may be inappropriate. For example, the regulations indicate that vouchers provided in \$5 increments up to the maximum monthly limit under the regulations would be appropriate for distribution to employees; however, vouchers provided only in an amount equal to the monthly limit would not be appropriate if employees did not normally have expenses that equal the monthly limit. [WARNING: Clients should consult with legal counsel or their tax advisor to determine if vouchers are provided in inappropriate denominations. The regulations do not provide clear guidance.]

If it is determined that vouchers are provided in inappropriate denominations, the vouchers are not readily available and cash reimbursement may be provided under the Plan regardless of the outcome of the 1% test in Step 2 above.

If it is determined that vouchers are provided in appropriate denominations, then the vouchers are readily available and the Plan may not provide for cash reimbursement of transit pass expenses.

[Click here](#) for a flowchart that provides a high level summary of the readily available test described above. 📄

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these lifestyles also change at different inflation rates than basic inflation.

While the basic inflation rate is about 3%, the U.S. Census Bureau noted that annual recreation costs increased at 7.14% throughout most of the 1990s. Healthcare costs also increased by much higher rates than the basic rate. Since the current retirement planning model bundles all costs - leisure, healthcare and basic living - and extrapolates at the basic rate, it tends to underestimate retirement expenses. The traditional model's static approach to retirement can have dangerous implications, including underfunded retirement plans, especially those earmarked for the critical years.

By contrast, the age-banded model provides a more accurate portrayal of retirement expenses and an algorithm to calculate the income-replacement ratio, as well as smaller resource requirements and greater flexibility in managing risk.

It also allows easier incorporation of long-term care insurance and significantly reduces funding needs. In fact, the savings needs of a husband and wife who are both age 60 and presumably five years away from retirement are reduced by more than 16%, and

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contributions for a 35-year-old single woman are reduced by 42% compared with previous approaches.

A flawed model

There are five inherent weaknesses to the traditional approach to retirement planning, specifically the traditional approach:

1. Assumes all living expenses will increase at the overall rate of inflation, as measured by the consumer price index
2. Bundles all expenses together without allowances for lifecycle changes
3. Estimates those expenses as a fixed percentage (replacement ratio) of pre-retirement costs
4. Invests in low-return assets
5. Fails to consider contingencies such as LTCI, which can significantly affect the amount savings required to secure retirement

When financial planners estimate how much income a client needs in retirement, the calculation hinges on their income just prior to retirement. Pre-retirement income is adjusted downward by 10% to 35%, reflecting the income necessary to maintain one's standard of living and incorporates reductions in taxes and other work-related expenses that cease upon retirement. Unfortunately, there's no objective way to estimate the replacement ratio.

Using the 30-year retirement window

Under the age-banded model, an individual typically lives about 30 years in retirement (age 65 to 95) and experiences a lifestyle change every 10 years at age 65, 75 and 85. Of course, both the retirement period and the width of the age bands are arbitrary but can be subjectively changed to fit each retiree as closely as possible.

In addition, a number of steps are taken to produce a clearer picture of retirement costs by categorizing them based on taxes, living expenses, healthcare and leisure, as well as calculating anticipated expenses using the appropriate rate of inflation for each category, which is adjusted to reflect postretirement lifestyle changes.

Those expenses are extrapolated through 30 years of retirement and the present value of post-retirement expenses are calculated at an amount deemed sufficient to finance the three following decades (each age band). Instead of discounting these values to the year of retirement (the traditional model), age-banding considers them to be three retirement portfolios that require funding.

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Since the portfolio required to fund expenses from age 86 to 95 is 20 years behind the first band (age 66 to 75), investors can seek marginally higher rates of return to reflect the longer terms. Contributions toward these amounts now can be calculated. For example, a 60-year-old couple can seek higher rates of return for longer-term investment portfolios which more than mitigate the effects of escalating health care costs. For the 35-year-old single woman, since the funds required for these three portfolios are 30, 40 and 50 years away she should be willing to take on more risk since she has ample time to manage the portfolio risk.

Expenses for the age-banded method become considerably higher at the latter stages of retirement, which is desirable since the overfunding coincides with an age at which one cannot afford to be out of money. The higher estimate of the age band comes from higher inflation rates for healthcare and the incorporation of lifestyle changes that imply accelerated costs such as increased leisure spending upon retirement and higher healthcare costs in the latter years.

Thus, these higher costs are not only more realistic but incorporate the dynamics of a retired life. Incredible as it might seem, the

ability to assume a marginally higher risk leads to a decrease in savings requirements, compared to the traditional model.

Financial planners need to keep in mind, though, that clients may be reticent to buy equities when markets are underperforming. Therefore, clear explanations are required regarding why it may still be beneficial for the long run and that risk will be managed on an ongoing basis. But the results will be well worth the effort in assuring that tomorrow's retirees are able to live more comfortably. It's a small price to pay for the peace of mind associated with knowing retirement expenses will be portrayed more accurately and plan participants will be afforded greater flexibility in managing risk.

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