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Cheryle A. Broom
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MANAGEMENT LETTER

DATE: February 25, 2003

TO: Metropolitan King County Councilmembers

FROM: Cheryle A. Broom, County Auditor

SUBJECT: Transit Pass Employee Benefit Tax Issue

This review was undertaken to determine whether a portion of the flexpass value is a taxable fringe benefit to employees and, if so, whether there are payroll tax liability issues for both the county and its employees.

Based on our research and the legal opinion of the Prosecuting Attorney's Office (PAO), the value of the transit pass (i.e., flexpass) provided by the county to all its employees does not exceed the statutory monthly limit of $100 ($65 per month prior to 2002), and the county's valuation of the flexpass meets the criteria of the Internal Revenue Code (IRC) for determining the fair market value of the transportation benefits. Consequently, there is no past or current payroll tax liability.

Our methodology for this review included identifying the applicable provisions in the IRC and how they affect King County's flexpass program. We requested the opinion of the PAO and discussed the issues with the council's legal counsel, the Executive Internal Auditor, and staff in the county's Department of Transportation. Their assistance was appreciated.

<u>Qualified Transportation Benefits</u>

Generally, the value of an employee fringe benefit is subject to federal income tax, unless the fringe benefit is specifically excluded by the Internal Revenue Code (IRC). IRC Section 132 identifies certain employee fringe benefits that are excluded from the definition of gross income, including a qualified transportation fringe. A "transit pass as any pass, token, farecard, voucher, or similar item (including an item exchangeable for fare media) that entitles a person to transportation – (a) On mass transit facilities (whether or not publicly owned)..." is a qualified transportation fringe. An employer-provided qualified transportation benefit is a taxable fringe benefit only to the extent the fair market value of the benefit exceeds $100 per month ($65 per month prior to 2002).

Fair market value is defined under the IRS regulation (Reg. 1.61 (21)) as "the amount that an individual would have to pay for the particular fringe benefit in an arm's length transaction." The IRS rule further states that the fair market value should be based on "all the facts and circumstances," and that "neither the amount the employee considers to be the value of the fringe benefit nor the cost incurred by the employer is determinative of its fair market value." If the qualified fringe benefit value exceeds the limit, the excess must be included in employee's wages for income and payroll tax purposes for the year. Likewise, the employer should recognize the applicable liability for payroll taxes.

<u>How Other Transit Agencies Value Transit Passes</u>

We researched the 34 largest transit agencies in the United States to identify those that had a program through which employers could provide transit passes to their employees. The majority offered such a program, and about one-third provided passes that were valued at more than $100 per month. All of the agencies whose passes exceeded $100 per month established their program so the transit passes were within the IRC statutory monthly allowance and therefore not a taxable fringe benefit. They accomplished this through measures such as providing employees with vouchers worth $100 to apply toward the purchase of a transit pass and coding passes up to a limit of $100 with the employee paying the difference at the fare box.

<u>County's Methodology in Valuing Flexpass</u>

The county's approach to determining the fair market value of the flexpass is different from that of other jurisdictions, because King County's flexpass is sold only to employers and cannot be purchased by individual employees.

The methodology used by the county in determining the value of this qualified transportation fringe benefit for county employees is the same as the one determining the amount charged to employers who buy flexpasses for their employees. The methodology is a cost-based formula that uses a combination of the average cost per trip and the actual or estimated number of employees in an organization who will use the flexpass. This formula results in a consistent methodology for establishing the price paid by each employer purchasing flexpasses but a different per-pass price for each employer. This approach conforms to the methodology established in the King County Code, Section 28.94.175, which states that the price of flexpass agreements shall be established according to the (statutory) schedule of annual calculations.

In the PAO's opinion, the fair market value of the flexpass for an employee is based on the amount that the employer must pay to obtain the pass for their employees. The amount for each employer, including King County, is calculated based on a formula adopted by ordinance. Employers are charged based on a calculation using trip revenue, baseline trips, and added trips. According to the PAO, "the individual value of the flexpass would then be the per employee value of the flexpass agreement." The total cost of the transportation benefit in 2001 was $2.3 million, of which $887,000 was from the current expense fund. Reimbursements to the Transit Division were made by interfund transfer, that were based on the number of employees (FTEs) who used the bus service. The value for each county employee was approximately $19 per flexpass per month, which is below the current IRS threshold of $100.

Initially, we were concerned that the county's approach to valuing the flexpass did not appear to conform to the IRS regulation cited above, because it includes cost as a factor and is based on value to the employer rather than the employee. However, the research of the PAO has determined that, while the county's flexpass is unique, it complies with the tax code and regulations: fair market value has been fairly established and applied. Given the complexity of the matter, it would behoove the county to monitor whether changes in the IRS code or changes in the flexpass program impact the taxability status of this employee transportation benefit in the future.

Bert Golla completed the review which was primarily conducted by Harriet Richardson, former Principal Management Auditor, and Mac Fletcher, Principal Financial Auditor who is on leave. Please contact Bert or me at 296-1655 if you have any questions about the issues discussed in this letter.

CB:BG:yr
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cc: Ron Sims, County Executive
Steve Call, Budget Director, Budget Office
Paul Tanaka, County Administrative Officer, Department of Executive Services
Harold Taniguchi, Director, Department of Transportation
Robert Cowan, Finance Manager, Finance and Business Operations Division
Dave Lawson, Internal Auditor Supervisor, Executive Audit Services
Peggy Pahl, Deputy Prosecuting Attorney
Shelley Sutton, Policy Staff Director, King County Council
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