CAPLAW enews brief

Tax Reform Update: Pre-Tax Salary Deferral Plans for Commuter Benefits Subject to UBIT

By Veronica Zhang, Esq.
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As highlighted in CAPLAW's February 2018 eNews Bulletin, the Tax Cuts and Jobs Act (the Tax Act), which was signed into law at the end of 2017, included numerous changes affecting tax-exempt organizations and their employees. One change we discussed was a new requirement for tax-exempt employers to pay unrelated business income tax (UBIT) on the expenses of providing certain "qualified transportation fringe" benefits to their employees on a tax-free basis. We stated that this provision did not affect a tax-exempt organization's ability to allow employees to pay for transportation costs on a pre-tax basis. That is, a nonprofit Community Action Agency (CAA) could continue to allow employees to pay for transportation or commuting benefits (e.g., mass transit passes or parking fees) with pre-tax income, up to the limits set annually by the IRS, without having to report the cost of the transportation benefits as unrelated business taxable income (UBTI).

The IRS, however, has since issued new guidance clarifying this requirement. In its most recent update to Publication 15-B: Employer's Tax Guide to Fringe Benefits, the IRS stated that for-profit employers may not claim a deduction for qualified transportation fringe benefits, even if they are provided through a "compensation reduction agreement." These "compensation reduction agreements" refer to employee benefit programs where employees are allowed to purchase mass transit passes or pay for parking costs using pre-tax dollars. The employee obtains the pass through his or her employer, and the employer deducts the cost of the pass from the employee's income, effectively reducing the employee's taxable compensation. The IRS sets annual limits for the pre-tax dollar amount that an employee can use for qualified transportation benefits. The limit in 2018 is $260 per month in qualified parking, or $260 per month for combined commuter highway vehicle transportation and transit passes.[1]

This means, by extension, that tax-exempt organizations must treat the employee pre-tax salary deferral for qualified transportation fringe benefits (i.e., the amount the employer deducts from its employee's wages to pay for a transit pass or parking costs) as UBTI, and report and pay taxes on those amounts. For example, if your nonprofit CAA administers a pre-tax cafeteria plan and offers employees the opportunity to purchase a $260 monthly commuter rail pass using pre-tax dollars, it must report this $260 as UBTI on its Form 990-T and pay tax at the applicable corporate tax rate (currently a flat rate of 21%), even if the CAA does not subsidize any portion of the cost of the pass.


This may seem illogical, since these amounts are neither “income” to the nonprofit CAA (unlike, for example, revenue generated from the CAA’s earned income ventures) nor “expenses” (since the employee is essentially paying for the transit pass or parking fees out of his or her own salary). This, however, is the result under the Tax Act, as one of the principles underlying the new law was leveling the playing field between taxable and tax-exempt employers. Under the Tax Act, when taxable employers are denied a deduction for their expenses associated with providing an employee fringe benefit, tax-exempt employers are required to pay a tax (UBIT) on the amount of the expense incurred for providing that same benefit to their employees, since tax-exempt entities typically do not make use of deductions (as they are generally exempt from paying taxes in the first place). This is the case even if the CAA merely deducts the entire cost of the parking fees or transit pass from an employee’s salary, and does not subsidize any of the employee’s parking or transit pass expenses.

These changes may cause some tax-exempt employers to reconsider whether to continue offering the pre-tax salary deferral cafeteria plans. While employers do not have to pay payroll taxes on amounts withheld from an employee’s salary to pay for these benefits, the current UBIT rate of 21% is significantly higher than federal payroll tax rates. Further, in some areas, including New York City, Washington, D.C., and the San Francisco metropolitan area, local laws require certain employers to offer qualified transportation benefits to their employees, so it may not be as easy to discontinue the benefits.

Filing Quarterly Estimated Taxes for UBIT

This tax on qualified transportation fringe benefits applies to amounts paid or withheld from an employee’s salary on or after January 1, 2018, regardless of when the CAA’s fiscal year begins. A CAA that anticipates owing more than $500 in UBIT should make quarterly estimated tax payments through the Electronic Federal Tax Payment System (EFTPS), which are generally due April 15, June 15, September 15, and December 15. A CAA can use Form 990-W to calculate its quarterly estimated tax payments, though this worksheet does not contain specific instructions for how to calculate UBIT for fringe benefits.

For more information about your CAA’s responsibilities to file quarterly estimated taxes, including what your CAA should do if it failed to make or underpaid the required payments for the first quarter of 2018, see this article from the law firm Venable LLP.

CAPLAW will continue to monitor the status of the law, including any guidance from the IRS regarding employer-provided parking, and will issue additional updates and resources as they become available.

Endnote:

[1] Rev. Proc. 2017-58 (providing that for taxable years beginning in 2018, the monthly limitation under IRC § 132(f)(2)(A) regarding the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and any transit pass is $260, and the monthly limitation under IRC § 132(f)(2)(B) regarding the fringe benefit exclusion amount for qualified parking is $260).

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