IRS Issues Final Regulations on Commuting Expenses Deduction Disallowances

A Practical Guidance® Article by
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On December 9, 2020, the IRS released final regulations implementing the Section 274(a)(4) and 274(l) deduction disallowances, adopted as part of the 2017 Tax Cuts and Jobs Act. 85 Fed. Reg. 81,391 (Dec. 16, 2020). Section 274(a)(4) disallows employer deductions for the cost of providing qualified transportation fringe (QTF) benefits provided to employees. Section 274(l) provides a broader deduction disallowance for expenses paid for, or to reimburse for, employees' trips between their residences and their places of employment. I.R.C. § 274. Both deduction disallowances took effect for tax years beginning after December 31, 2017.

The final regulations largely follow the approach taken in the proposed regulations issued in June, which built on earlier guidance provided in Notice 2018-99. Treasury Regulation § 1.274-13 addresses the deduction disallowance under section 274(a)(4) for the cost of QTFs provided under section 132(f), such as qualified parking, transit passes, and other tax-free commuting benefits. Treasury Regulation § 1.274-14 addresses the deduction disallowance under section 274(a).

Although the approach of the final regulations is generally unchanged from the proposed regulations (discussed in detail in our earlier coverage), the IRS did make a few noteworthy changes in response to taxpayer comments, discussed below:

Parking with No Objective Value

The IRS rejected a commenter's suggestion that parking with no objective value, such as parking in industrial, remote, or rural areas (i.e., areas where the general public would not pay to park) is not a QTF. The Preamble to the final regulations indicates that Treasury and the IRS do not believe the value of parking to an employee is relevant in determining whether the parking itself constitutes qualified parking. Although it seems somewhat illogical to consider value irrelevant to determining whether the value of a benefit is excluded from income, the IRS apparently believes that, even if the amount excluded from the employee's income under Section 132(f) is zero, the provided parking is still "qualified" and therefore a QTF. I.R.C. § 132. Nonetheless, Treasury and the IRS determined that no deduction disallowance is necessary in such cases. In such event, the exception under Section 274(e)(8) applies because, if the value of the parking is zero and therefore the employee is not charged, the employee should be considered as having paid adequate and full consideration for the parking.

It remains to be seen how broadly this exception may be applied. Although the Preamble mentions rural areas, parking is generally provided without charge in exurban and even many suburban locales. Similarly, parking is generally provided in business parks in such areas without charge and the general public would not pay to park in such areas. The application of Section 274(e)(8) to parking provided in such areas would seem to significantly reduce the impact of the disallowance outside of large cities and downtown areas.

Parking at Multi-Tenant Buildings

In response to commenters' requests, the final regulations clarify that "general public" includes employees, partners, 2-percent shareholders of S corporations, sole proprietors, independent contractors, clients, or customers of unrelated tenants in a multi-tenant building, as well as customers, clients, or visitors of the taxpayer, individuals delivering goods and services to the taxpayer, students of educational institutions, and patients of health care facilities. The clarification should help many employers in multi-tenant buildings avoid the deduction disallowance, because, under the regulations' primary purpose test, the majority of the parking at the building will be available to the general public unless the employer occupies a large portion of the building.

Peak Demand Period

Several methodologies for determining the disallowance under Section 274(a)(4) require the employer to determine the total number of parking spaces used by employees during the peak demand period for employee parking on a typical day. In light of comments regarding the COVID-19 pandemic, the final regulations permit employers to determine the cost per space method using the peak demand period on a monthly basis to allow employers to account for fluctuations in the number of employees working at the worksite during the year. In addition, if a taxpayer owns or leases a parking facility in a federally declared disaster area, as defined in Section 165(i)(5), the employer may use a typical business day in the tax year prior to the year in which the taxpayer's business was impacted by the disaster in measuring usage during the peak demand period. The rule applies to tax years ending after December 31, 2019.

Special Rule for Mixed Parking Expenses

The proposed regulations included a special rule that allowed taxpayers to allocate 5% of mixed expenses (such as payments under a lease or rental agreement, utilities, insurance, interest, and property taxes). The special rule could only be used under the primary use methodology (the methodology originally detailed in Notice 2018-99) and the cost-per-space methodology included in the proposed regulations. The final regulations permit an employer to use the special rule when using the general rule, which allows the employer to use "any reasonable methodology" to determine the amount of the disallowance. In addition, employers that elect to use the "qualified parking methodology" are permitted to use the special rule to determine total parking expenses.

Cost-Per-Space Methodology

The final regulations generally retain the optional cost-per-space methodology included in the proposed regulations. However, the cost-per-space (total parking expenses, including expenses related to inventory/unusable spaces, divided by total parking spaces, including inventory/unusable spaces) must be multiplied by the number of total parking spaces used by employees during the peak demand period. The proposed regulations had inadvertently excluded reserved employee spaces from the number of spaces used to calculate the disallowance.

Scope of Section 274(l)

The final regulations helpfully clarify two points that were raised by practitioners. Section 274(l) applies to costs incurred for an employee's trip between the employee's residence and place of employment. If interpreted broadly, the provision could be read to disallow the deduction for expenses incurred for trips between the employee's residence and temporary places of employment, both daily trips excludible from income under Rev. Rul. 99-7, and overnight trips away from the employee's tax home. The final regulations clarify that the disallowance does not apply to trips between the employee's residence and temporary place of employment. Nor does it apply to costs that qualify as business expenses under I.R.C. Section 162(a)(2) for travel away from home.

Definition of Employee

The final regulations include a definition of employee for purposes of Section 274(l). That definition incorporates the definition of employee for purposes of FICA taxes (i.e., officers of a corporation and common law employees).

Exception under Section 274(l) for Costs Incurred for Employee Safety

In response to a comment filed by Covington & Burling and others, the final regulations broaden the circumstances under which an employer may deduct expenses for an employee's commute for the employee's safety. The proposed regulations limited the exception to "bona fide business-oriented security concerns" under the working condition fringe benefit rules. Those rules generally apply to executive security programs and require either around-the-clock security or an independent security study documenting the need for the security provided. The final regulations rely instead on the definition of "unsafe conditions" under the fringe benefit valuation rules in Treasury Regulation § 1.61-21(k). Accordingly, employers may deduct expenses for an employee's commute if a reasonable person would, under the facts and circumstances, consider it unsafe for the employee to walk to or from home, or to walk to or use public transportation at the time of day the employee must commute.

Related Content

Lexis Tax

- IRC Sec. 274
- Lexis Explanation IRC Sec. 274(n)
- Taxation of Compensation and Benefits P 2.03, "Specific exclusions"
- 85 Fed. Reg. 37,599 (June 23, 2020)
- 85 Fed. Reg. 81,391 (Dec. 16, 2020).
- I.R.S. Notice 2018-99
- Rev. Rul. 99-7

Practical Guidance

- Cost of Living Adjustments Chart for Employee Benefit Plans
- Fringe Benefit Rules (IRC § 132)
- 2017 Tax Act Impact on Employee Benefits and Executive Compensation
- Tax Cuts and Jobs Act of 2017

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Michael Chittenden practices in the areas of tax and employee benefits with a focus on the Foreign Account Tax Compliance Act (FATCA), information reporting (e.g., Forms 1095, 1096, 1098, 1099, W-2, 1042, and 1042-S) and withholding, payroll taxes, and fringe benefits. Mr. Chittenden advises companies on their obligations under FATCA and assists in the development of comprehensive FATCA and Chapter 3 (nonresident alien reporting and withholding) compliance programs.

Mr. Chittenden advises large employers on their employment tax obligations, including the special FICA and FUTA rules for nonqualified deferred compensation, the successor employer rules, the voluntary correction of employment tax mistakes, and the abatement of late deposit and information reporting penalties. In addition, he has also advised large insurance companies and employers on the Affordable Care Act reporting requirements in Sections 6055 and 6056, and advised clients on the application of section 6050W (Form 1099-K reporting), including its application to third-party payment networks.

Mr. Chittenden counsels clients on mobile workforce issues including state income tax withholding for mobile employees and expatriate and inpatriate taxation and reporting.

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Ms. Dyson advises large employers on the application of employment taxes, the special FICA tax timing rules for nonqualified deferred compensation, the voluntary correction of employment tax errors, and the abatement of late deposit and information reporting penalties for reasonable cause. On behalf of the restaurant industry, her practice provides extensive experience with tip reporting, service charges, tip agreements, and Section 45B tax credits.

Marianna is a frequent speaker at Tax Executives Institute (TEI), the Southern Federal Tax Institute, and the National Restaurant Association.