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Editor's Note

In an effort to keep you informed of regulation issues and new developments, we will be sending quarterly issues of our newsletter, **Benefits Briefing**. If there are HR contacts at your company who would benefit from this, please give us their names and email addresses, and we will add them to the distribution list.

IRS ISSUES UPDATED 2006 VERSION OF Publication 502 MEDICAL AND DENTAL EXPENSES

Publication 502 is the guide for taxpayers to use in determining deductible medical expenses for tax returns. Medical expenses are only deductible on individual tax returns to the extent that they exceed 7.5% of the taxpayer's adjusted gross income (and therefore infrequently deductible on an individual return).

Highlights include the medical mileage rate in 2006 at \$.18/mile. This rate will increase to \$.20/mile for 2007.

Caution should be used in relying on Publication 502 for determining expenses reimbursable from Health Care Flexible Spending Accounts (FSA). Although Publication 502 is the best source for IRS provided reference material for reimbursable medical expenses, some differences exist between deductible medical expenses on an individual's tax return and expenses reimbursable from an FSA.

Differences include:

- Expenses reimbursed from an FSA must be incurred during the plan year, while expenses are deductible on the tax return in the year they are paid.
- Over the Counter Drugs may be reimbursable from an FSA, but are not deductible on a tax return.
- Medical Insurance premiums are deductible on a tax return, but may not be reimbursed from an FSA.
- Long-Term Care expenses may be deductible on a tax return, but are not reimbursable from an FSA.

2006 Updated Publication 502 Medical and Dental Expenses is available at <http://www.irs.gov/pub/irs-pdf/p502.pdf>

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IRS RELEASES 2006 IRS FORMS 2441 AND 1040A (SCHEDULE 2)

The IRS has released Form 2441 ("Child and Dependent Care Expenses") and its accompanying Instructions for the 2006 tax year. Form 2441 is a dual-purpose form. Taxpayers file it with Form 1040 to determine the amount of their dependent care tax credit (DCTC); they also use it to establish that the amounts in Box 10 of Form W-2 (the value of employer-provided dependent care (DCAP) benefits) are not taxable. Form 1040A (Schedule 2) is the abbreviated version of Form 2441 used by taxpayers who file the short Form 1040A. It too has been released for 2006, along with its accompanying instructions.

The 2006 Form 2441 is substantially similar to the 2005 version, with one significant difference: a new line 13 has been added to report any amount carried over from 2005 and used in 2006 during a grace period for an employer-provided DCAP. (Under IRS guidance issued in 2005, an employer may amend its cafeteria plan to allow participants to access unused amounts in their health FSAs or DCAPs during a grace period of up to two and a half months after the end of the plan year--see our article at

IRS guidance continues to allow employers to report in Box 10 of Form W-2 only the DCAP salary reduction amounts elected by employees for the year (and any related matching contributions), rather than actual reimbursements for the year--whether or not the DCAP has a grace period.

Copies of Form 2441 and Instructions are available at:

<http://www.irs.gov/pub/irs-pdf/f2441.pdf> and <http://www.irs.gov/pub/irs-pdf/i2441.pdf>

Copies of Form 1040A (Schedule 2) and Instructions are available at: <http://www.irs.gov/pub/irs-pdf/>

[f1040as2.pdf](#)

and <http://www.irs.gov/pub/irs-pdf/i1040as2.pdf>

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QUALIFIED TRANSPORTATION BENEFIT LIMITS INCREASED FOR 2007

For 2007, the monthly limit on the amount that may be excluded from an employee's income will be \$215 for qualified parking benefits (a \$10 increase from the 2006 limit) and \$110 for transit and vanpooling expenses combined (a \$5 increase from the 2006 limit).

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IRS ISSUES GUIDANCE PERMITTING USE OF SMARTCARDS AND DEBIT CARDS FOR TRANSIT EXPENSES

[Rev. Rul. 2006-57, 2006-47 I.R.B. 911 (Nov. 20, 2006)]

On November 20, 2006 the IRS issued Revenue Ruling 2006-57 permitting the use of smartcards and certain debit card arrangements to provide tax-free transit expenses under qualified transportation fringe benefit plans. Employers that offer qualified transportation fringe benefits to employees may not provide cash reimbursements for the cost of transit passes if a voucher (accepted by a transit operator as fare media) is "readily available" to an employer for distribution to employees. There are no employee substantiation requirements if an employer distributes vouchers to its employees.

When cash reimbursements are permitted, third-party substantiation and employee certification generally are required. This ruling analyzes various card arrangements to determine whether each is permissible and whether the cards serve as "vouchers," thereby avoiding substantiation requirements.

Highlights include:

Smart Cards and Terminal-Restricted Debit Cards are Permitted and are Vouchers. Smartcards are plastic cards containing a memory chip that stores the serial number of the card and the value of the fare media stored on the card. The fare media stored on the smartcard cannot be used for anything other than the transit system. A terminal-restricted debit card is a debit card restricted for use only at merchant terminals that sell fare media for a transit system. In the ruling, amounts that are within the legal monthly limit for transit passes (\$110 for 2007) are allocated monthly to each card. The IRS ruled that both smartcards and terminal-restricted debit cards are vouchers. Thus, employees do not need to substantiate expenses paid

with these cards, and employers do not need to review whether another voucher is "readily available" in a particular area.

Merchant Category Code - Restricted Debit Cards May Be Permitted but are NOT Vouchers. The IRS also ruled that debit cards that are restricted by a merchant category code (MCC) may be a permissible method of providing tax-free transit benefits, if certain requirements are met, but they are not considered vouchers. Even though the cards in the ruling are restricted to merchants that have been assigned MCCs indicating that fare media for certain categories of transportation is sold by the merchants, the IRS concludes they are not vouchers because it is possible that the merchants also sell merchandise other than transit passes. Because they are not vouchers, MCC-restricted debit cards cannot be used in an area where another voucher is "readily available," and the card arrangement must meet the requirements of a "bona fide reimbursement arrangement" (under which substantiation of expenses is required and advances are prohibited). The ruling requires stringent substantiation and certification procedures.

The ruling is effective January 1, 2008 and can be relied on prior to that date. Employers currently providing plans using debit cards will need to review their arrangements to see if compliance changes should be made to their programs. The ruling does not provide guidance on using cards for parking expenses, but based on informal comments from IRS official, it will most likely be permissible to use MCC-restricted debit cards designed to pay parking expenses in arrears under substantiation and certification requirements like those in the ruling. so long as the parking expenses came out of a separate "purse" of money than mass transit expenses (or were loaded to a separate card).

A copy of the ruling is available at: <http://www.irs.gov/pub/irs-irbs/irb06-47.pdf>

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IRS Publication Links

With tax season upon us we wanted to provide you with some handy links to IRS Publications that may help you and your employees. We hope they are helpful to you.

[IRS Publication 502 \(Health Care\)](#)

[IRS Publication 503 \(Dependent Care\)](#)

[IRS Publication 969 \(HSAs and Other Tax-Favored Health Plans\)](#)

[IRS Publication 968 \(Adoption\)](#)

[Other IRS Publications](#)

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