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*Prepare for a potential IRS audit or compliance check by learning about common problematic issues for cities such as expense reimbursements, fringe benefits and payroll issues like social security and Medicare wages for police and fire employees, social security for elected officials and tax treatment for common health insurance issues.*

**RELEVANT LINKS:**

IRS: Tax Information for  
Federal, State, and Local  
Government.  
MN FSLG Specialist  
Contact Lori Stieber  
[Lori.A.Stieber@irs.gov](mailto:Lori.A.Stieber@irs.gov)

## **I. What to expect from an IRS payroll audit**

A letter arrives from the Internal Revenue Service notifying you of a payroll audit. What do you do? What should you expect? While many cities have not experienced an IRS payroll audit, it's important to know what to expect. As part of the Employment Tax Research Project (ETRP), the IRS focused reviewing payroll practices of employers in these main areas: worker misclassification, compensation recognition (one example of this are retirement payouts of vacation or sick leave that should be recognized as wages), fringe benefits (such as personal use of government vehicles, meal reimbursements without an overnight stay and clothing reimbursements), and payroll taxes (such as appropriate taxation for Federal Income Tax and Social Security).

The Federal, State, and Local Government Division (FSLG) of the IRS is responsible for ensuring federal tax compliance by governmental entities, encouraging voluntary compliance, and providing individualized assistance. FLSG has one representative agent in the state of Minnesota whose office is located in Bloomington (contact information is provided to the left). Generally, the IRS may conduct a review of cities at one of two levels; compliance checks or examinations.

### **A. Compliance checks**

Smaller entities, typically those with \$4 million or less in payroll, may be the subject of a compliance check.

Compliance checks often involve an IRS agent meeting with the appropriate representative of the organization, asking a series of established questions, and educating the organization about what they need to do to be in compliance. Compliance checks may not involve detailed review of the organization's books and records.

This material is provided as general information and is not a substitute for legal advice. Consult your attorney for advice concerning specific situations.

IRS Accountable plans definition.

Rev. Proc. 2008-59.  
MN Office of the State Auditor: Taxable Employee Expense Reimbursements.

## B. Examinations

Alternatively, review activity may consist of an examination. Examinations are necessary when compliance problems are identified requiring analysis of the organization's books and records.

Examinations involves the IRS agent requesting and reviewing the books and records of the organization along with more extensive interviews, sampling, and analysis similar to other annual audits that municipalities undergo . Adjustments to reported compensation is usually made but sometimes it is a decrease and sometimes an increase. The payments due in most cases consist of the taxes that should have been withheld and deposited by the employer for both the employee and the employer portions of those taxes. Penalties are sometimes assessed as well.

## II. Compliance areas

Compliance issues are common in two areas: reimbursements and fringe benefits.

### A. Reimbursements

Reimbursements, are nontaxable to the recipient only if they are provided through an "accountable plan" which meets certain requirements. An accountable plan, which does not necessarily need to be a written plan, is generally one under which expenses are reimbursed only if there is a business connection to the expenditure, there is an adequate accounting of the expenditure and any excess reimbursements are returned to the employer. Absent these requirements, the plan is a "non-accountable plan" and payments are taxable wages to the employee.

#### (1) Expenditure has a business connection

The individual must have paid or incurred a deductible business expense in connection with services performed as an employee.

#### (2) Reasonable accounting of expenses

The employer must have some reasonable accounting for the expense such as verifying the date, time, place, amount, and business purpose of the expense. Receipts are required unless reimbursed under a per diem plan.

#### (3) Repayment of excess reimbursements or advances

Excess reimbursements or advances must be repaid to the city within a reasonable period of time.

**RELEVANT LINKS:**

IRS: Quick Reference Guide for Public Employers.

IRS: Employers Tax Guide to Fringe Benefits.  
26 USC § 119.

IRS Regulation § 1.119(a)(2)(ii)(a).

26 C.F.R. § 1.119-1.

26 C.F.R. § 1.132-6.

IRC § 162(a)(2).

MN Office of the State Auditor: Meal Reimbursements May Be Taxable.

IRC § 132(e).

The amount of time that is reasonable depends on facts and circumstances, but generally within 120 days of the advance being made or the employer providing a periodic statement (e.g. quarterly) the excess amount must be returned.

**(4) Meals**

For meals to be excludable from an employee's wages, the general rule is the meals must be provided:

- On the employer's business premises - the meals must be provided either at a place where the employee performs a significant portion of their duties, OR the premises where the employer conducts a significant portion of his or her business. AND
- They are for the employer's convenience - if meals are provided for a substantial "non-compensatory" reason; that is, the intent is not to provide additional pay for the employee or cover personal expenses of the employee, but for business reasons, it is in the best interest of the employer to provide the meal.

Generally speaking, the following meal expenses would be excludable from employee wages:

- A meal for an occasional office meeting for the convenience of the employer (perhaps lunch ordered for a quarterly department meeting).
- A meal during conferences or seminars, for example a breakfast or lunch buffet provided to conference attendees.
- Occasional meals or meal money provided to enable an employee to work overtime, such as pizza for snowplow drivers working extended shifts due to a snowstorm.
- Employee reimbursement for meal expenses incurred on business travel with an overnight stay. The IRS general rule is a meal is subject to tax withholding when an employee is reimbursed for meals but does not stay overnight. Also refer to de minimis meals below.

The IRS excludes de minimis fringe benefits from taxes; "de minimis fringe" means any property or service the value of which is (after taking into account the frequency with which similar benefits are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable. While there is no specific dollar limitation provided for in IRS regulations for determining whether a benefit is de minimis, generally speaking, de minimis includes employer provided benefits that have so little value that accounting for them would be unreasonable or impracticable. Examples of de minimis meals include:

- Office snacks like coffee, doughnuts, bottled water or soft drinks provided to employees on site.
- Occasional parties or picnics for employees and their family and guests.

**RELEVANT LINKS:**

TAM 200030001.

IRS, Publication 15b.  
IRS: Employees Pay.  
IRS: FSLG Fringe Benefit  
Guide.  
26 C.F.R. § 132.

IRS: Employees Pay.

IRC Section 74(c).  
26 U.S.C. § 74.

IRS: Issues Guidance on Tax  
Treatment of Cell Phones;  
Provides Small Business  
Recordkeeping Relief.  
IRS Notice 2011-72.

For detailed information see  
IRS Publication 15-B,  
"Employer's Tax Guide to  
Fringe Benefits".

- If an employee attends a conference where, for example, a buffet type luncheon is offered to conference attendees, generally speaking that large group meal will not be subject to tax withholding since the conference is occasional and the inherent difficulty in tracking to determine whether the city employee actually ate the luncheon provided.

Keep in mind, however, this is general information, and each situation is unique. The value of meals, for example, provided to employees at business conferences, ranging in cost from \$109 to \$709 per participant were not considered by the IRS to be de minimis fringe benefits, and thus, subject to taxes

## **B. Fringe benefits**

IRS Treasury Regulation 1.61-21 provides fringe benefits provided to employees are taxable wages unless a specific exclusion from income applies. Examples of fringe benefits excluded from income include:

- accident and health benefits,
- achievement awards (up to \$1,600 for "qualified" rewards. A qualified plan award is an achievement award given as part of an established written plan or program that does not favor highly compensated employees as to eligibility or benefits.
- adoption assistance,
- dependent care assistance (up to \$5,000 per household),
- educational assistance (up to \$5,250),
- group term life insurance (up to \$50,000), and
- health savings accounts (up to contribution limits). For 2013, a person can contribute up to \$3,250 for self-only coverage or \$6,450 for family coverage to a qualified individual's HSA. The contribution amounts listed above are increased by \$1,000 for a qualified individual who is age 55 or older at any time during the year. For two qualified individuals who are married to each other and who each are age 55 or older at any time during the year, each spouse's contribution limit is increased by \$1,000 provided each spouse has a separate HSA.

In 2011, the IRS issued guidance in Notice 2011-72, on the treatment of employer-provided cell phones as an excluded fringe benefit. Notice 2011-72 provides that when an employer provides an employee with a cell phone primarily for non-compensatory business reasons, the business and personal use of the cell phone is generally nontaxable to the employee, and the IRS will not require recordkeeping of business use in order to receive this tax-free treatment.

RELEVANT LINKS:

Minn. Stat. § 471.666.

IRS: Quick Reference Guide for Public Employers.

IRS: Quick Reference Guide for Public Employers.

IRS: Quick Reference Guide for Public Employers.

While all of these benefits are excluded from federal income tax withholding not all are excluded from Social Security, Medicare and federal unemployment (FUTA) tax. Some benefits may also have limits in terms of what is excluded, so anything exceeding those limits would be considered taxable income (e.g. group term life insurance over \$50,000). Note that the limits change.

### (1) Take Home Vehicles

Minnesota Statute permits, in some situations, for an employee to bring home a city vehicle in connection with work-related activities. However, the personal use of a government-owned vehicle is generally a taxable fringe benefit to an employee. The value of the benefit must be included in wages, but withholding of income tax on the value of vehicle use is at the employer's option. Social security and Medicare withholding is required. Use of an employer-provided car is taxable income to the employee unless the type of vehicle and usage meets strict IRS criteria.

In order for a take home vehicle to be nontaxable to an employee, it must meet the IRS definition of a "qualified non-personal use vehicle." A qualified non-personal use vehicle is a vehicle the employee is not likely to use more than minimally for personal purposes because of its design. Typical qualified non-personal use vehicles include, but are not limited to:

- Clearly marked police, fire, and public safety officer vehicles. The employee must be on-call, required to commute in the vehicle, and be prohibited from personal travel outside the jurisdiction.
- Unmarked vehicles used by law enforcement officers. The officer must be authorized to carry a firearm, execute search warrants and make arrests.
- An ambulance or hearse used for its specific purpose.

In the event a city provides an employee with a vehicle that does *not* meet the qualified non-personal use criteria, the personal use of the vehicle is a taxable fringe benefit. It is the employer's responsibility to determine the actual value of this fringe benefit and to include the taxable portion in the employee's income.

In the link to the left, the IRS details a different situation where an "on call" employee is permitted to drive home a city-owned pick-up truck marked with the city's name on it (thus, the vehicle is not a police, fire, or public safety vehicle). Since the vehicle is not a qualified non-personal use vehicle, in this situation the commuting would be a non-cash taxable fringe benefit to the employee.

**RELEVANT LINKS:**

IRS: FSLG Fringe Benefit Guide.

See Section II A Reimbursements.

IRS: Quick Reference Guide for Public Employers.

Treas. Reg. § 1.132-6(d)(4).

IRS: FSLG Fringe Benefit Guide.

IRS: FSLG Fringe Benefit Guide.  
IRS: Publication 15-B - Main Content.

PERA: Minnesota's 218 Agreement.

**(2) Clothing reimbursements**

Generally, a clothing reimbursement for a police officer or firefighter uniform qualifies for exclusion from income if it meets all the requirements of an accountable plan (recall an accountable plan must include a qualified expense, substantiation, and return of excess reimbursements). Additionally, a uniform must be required as a working condition of employment and the clothes cannot be suitable for everyday wear.

In the event the clothing does not qualify as a deductible expense then the clothing reimbursement must be treated as a taxable fringe benefit and, therefore, is subject to income, social security and Medicare taxes. As the IRS link to the left describes, a detective's suit jacket and related clothing, for example, since they are suitable for everyday wear, do not qualify as a uniform and, thus, are taxable to the employee.

If a city provides a fringe benefit to employees and there is no basis for exclusion under the IRS code, there are significant consequences both to the city and to the employee, including:

- The employee is liable for individual income taxes on the entire benefit value of the benefit.
- The employer is liable for the taxes it did not withhold and there may also be additional penalties.

**III. Common audit and payroll issues**

**A. Audit Issues**

Some of the top IRS audit issues applicable to cities and their tax issues are outlined in Appendix A. Topics covered are athletic and fitness facilities, car and clothing allowances, employer-provided vehicles and gift cards. Detailed information on these topics is available from the IRS' Federal State and Local Governments (FSLG) Division. You may contact Lori Stieber at FSLG by email at [lori.a.stieber@irs.gov](mailto:lori.a.stieber@irs.gov) if you have questions.

**B. Payroll Issues**

The following topics are common payroll topics about which the League receives questions from member cities:

**(1) Medicare wages for police and firefighters.**

Questions frequently arise over whether cities must pay Social Security or Medicare wages for police officers and firefighters.

## RELEVANT LINKS:

Employer Manual, PERA,  
Chapter 7, Contribution  
Reporting.

Police officers and firefighters, who are member of the PERA Police and Fire plan, do not pay the Social Security portion of FICA taxes, but may be required to pay into Medicare. Medicare participation is required for police officers or firefighters who are hired after March 31, 1986. If a police officer or firefighter was hired before April 1, 1986, is a member of the PERA Police and Fire Plan, and has been continuously employed by the same employer, the employee is exempt from Medicare participation, unless provided for in a Section 218 Agreement.

### **(2) Severance pay for continued health insurance**

Whether severance pay for continued health benefits is non-taxable is a common issue. At issue is whether or not the employee has the option of receiving cash or receiving insurance. Employees are not permitted to have the option of receiving cash as an alternative for this option to be considered tax exempt. Funds must never be in the possession of the employee. Unless provided for in a severance agreement, collective bargaining agreement or a personnel policy, it is the employee's responsibility to pay for continued insurance benefits when they leave the city's employment. Some cities pay a former employee's insurance premiums from sick leave credits, vacation time credits, and/or severance pay. In order to receive this benefit on a tax favored basis, the dollars need to be transferred directly from the employer to the provider's plan that allows for the tax benefit.

Sometimes cities wish to consider paying COBRA premiums as part of a severance package for a terminating employee. Since there are tax consequences dependent upon the arrangement structure, it is vitally important the city work with legal counsel prior to agreeing to any such arrangement.

IRS Information Letter 2006-0042.

Generally, if a city gives money to a former employee to pay, for example, health insurance premiums, and the money can be used in any way by the former employee (and thus no guarantee the individual will use the funds to pay the insurance premiums), then that payment is taxable to the former employee as wages.

IRS Information Letter 2006-0042.

Alternatively, if the city instead pays the premiums directly to the insurer or reimburses the ex-employee for the actual paid premium, then that insurer payment or former employee premium reimbursement will be considered nontaxable and excluded from wages. If the city chooses to reimburse the employee for the paid premiums in this way, it is crucial the city requires the former employee to provide documentation verifying payments were made to the insurer. If there is no verification the employee used the city funds to pay for the premiums, then the amount would be included as wages and subject to taxes.

## RELEVANT LINKS:

IRS: Supplemental Wages.

IRS: Employer's Supplemental Tax Guide.

IRS: Bulletin: 2008-24.

HR Reference Manual, Chapter 4.  
HR Reference Manual, Chapter 5.

LMC information memo, *Employee or Independent Contractor*.

IRS: determining employee v. independent contractor status.

It is important to note this memo only provides general information regarding IRS taxability for these types of arrangements. A city will want to work with its benefits specialist to consider whether nondiscrimination testing, especially with respect to Health Care Reform, will impact any such premium paid arrangement for former employees.

### **(3) Severance payouts on accrued vacation and sick time**

Generally, severance pay as well as payments for any accumulated vacation or sick time are taxable and reportable as wages. When vacation or sick pay is in addition to regular wages typically those vacation and/or sick hours will be treated as a supplemental wage payments. Whether wages are classified as regular wages or supplemental wages for payroll purposes is dependent upon several conditions outlined in IRS Publication 15-A and Revenue Ruling 2008-29 (links provided to the left).

Municipal employers may offer employees a post-employment health savings plan established under Internal Revenue Code Section 105. Employees choose the option well in advance of retirement to qualify for tax exempt status of applying sick leave credit, vacation time credit, or severance due to health care retirement accounts.

### **(4) Independent contractors versus employees**

The IRS has developed guidelines to help cities determine whether an individual is an independent contractor or whether they are an employee. Generally, the Internal Revenue Service recognizes three categories of facts to consider when making a determination of employee status, including behavioral control, financial control, and relationship of the parties. The amount of control exerted by the individual in how work is performed is the single most important factor when determining whether they are an independent contractor or employee. Some cities mistakenly think an individual is an independent contractor when in fact the individual should be an employee.

In addition, how an independent contractor is paid versus an employee is different. Independent contractors should be paid through accounts payable and employees are paid through payroll. Hiring an individual as a contractor when they really should be an employee has significant tax, PERA, and workers' compensation consequences, as well as subjects the employer to various penalties and interest charges.



**RELEVANT LINKS:**

IRS: Voluntary Classification Settlement Program.

IRS: Bulletin: 2012-51.

PERA: Elected Officials.  
PERA: Elected Officials Eligibility.  
PERA: Social Security and Medicare Coverage For Newly Elected Local Officials.

PERA: Minnesota's 218 Agreement.

HR Reference Manual, Chapter 4.  
HR Reference Manual, Chapter 5.

If there has been an improper classification, the Voluntary Classification Settlement Program (VCSP) allows eligible employers, including governmental entities, to voluntarily reclassify workers as employees for future tax periods with partial release from federal employment taxes for the past misclassification, on a prospective basis and get into compliance by paying 10 percent of the employment tax liability that may have been due on compensation paid to the workers for the most recent tax year.

**(5) Elected officials**

Elected officials are considered to be employees by the Internal Revenue Code and need to be issued W-2s. Whether they pay into Social Security is a separate issue.

Effective July 1, 1990, elected officials have the opportunity to participate in PERA's defined contribution plan (DCP). They can elect to participate in the DCP any time after they are elected to office. DCP is the only PERA retirement plan available to officials elected to governing body positions (ex: city council, county board, school board, etc.) after June 20, 2002. Elected officials participating in the plan may choose to discontinue participation at any time.

Participation in the DCP may have implications for whether the elected official pays Social Security – Medicare participation is required for any official elected after March 31, 1986. However, many elected officials are not eligible to participate in Social Security if they also participate in the DCP.

In order for elected officials to participate in both the DCP and Social Security, the local governmental entity would need to amend its Section 218 Agreement to allow for elected officials to also participate in Social Security. Elected officials not participating in the DCP are required to participate in Social Security.

**(6) Individual health insurance**

Generally, extra cash provided to an employee to purchase insurance on their own is taxable income. To be non-taxable, the city must have a cafeteria plan in place. A written plan document is necessary and the payment of the individual health insurance premium must be substantiated (e.g. employees submit monthly the billing statement from their insurance company).

## RELEVANT LINKS:

"Compensating Employees on Workers' Comp Leave." *Minnesota Cities* (May 2005, p. 21).

IRS: FSLG Newsletter -- July 2008.

IRS: The Mortgage Forgiveness Debt Relief Act and Debt Cancellation.

Payment of individual health insurance premiums may be made in various ways, including the individual paying the premium first and then submitting for reimbursement, or direct payment by the employer to the insurance carrier.

Potential issues are involved when paying individual health insurance on a tax favorable basis. It is not clear how the Department of Labor would view these arrangements. It's possible the city may be seen as setting up an alternative "group" and HIPAA, COBRA, and other group benefit regulations may apply. Individual policies are not designed with these types of group benefit regulations in mind and compliance may be difficult. In addition, there may be legal issues associated with providing cash in lieu of benefits under federal health care reform provisions, although many of those provisions have not yet been clarified as of the date this memo was updated.

### **(7) Supplementing workers' compensation benefits**

Minnesota workers' compensation law stipulates a city can provide payment of additional benefits to employees receiving workers' compensation benefits. The payment can be made from accumulated sick leave, vacation or compensatory time, or not charged to any leave category – just simply paid by the city.

Many cities make up the difference between a workers' compensation lost-wage payment and the employee's normal gross weekly wages by allowing use of accrued sick leave or vacation time. Cities may also pay the employee's normal gross weekly wages while waiting for the workers' compensation benefit to begin.

If the city engages in any practice of paying benefits while an employee is on workers' compensation leave, the city should make any necessary adjustments so the workers' compensation payment is not treated as taxable income for the employee. Adjustments must be made to the employee's compensation – either on a pay-period basis or at year end.

### **(8) Exclusions for firefighters and emergency responders**

The Mortgage Forgiveness Debt Relief Act of 2007 provides certain tax benefits for volunteer firefighters and emergency responders. Among other things, the law provides that the value of certain benefits – up to \$30 for each month of service during a calendar year – may be excluded from income tax, social security, and Medicare withholding. The maximum exclusion is \$360 per year for each employee.

This Act was extended through 2013. More information about these exclusions can be found in the section Exclusion for Firefighters and Emergency Responders on the IRS web site.

**RELEVANT LINKS:**

IRS: 941 for 2013.

800.925.1122  
651.281.1200  
HRbenefits@lmc.org

## **IV. Compliance issues and resources**

If an organization is audited and found to be in noncompliance, an adjustment will be made to the tax return (Form 941) to correct the errors found during the exam. In some cases penalties are assessed in addition to the adjusted compensation and withholding taxes. The city and its employees may be subject to taxes due on amounts that were incorrectly determined to be non-taxable, which would also require issuing amended W-2s. It could also require employees to file amended tax returns for past (prior) years.

## **V. Further assistance**

If you have any additional questions please contact the League's Human Resources and Benefits Department.