INFORMATION MEMO

IRS Audits of City Payroll: Payroll Pandemonium

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.

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.

Generally, the IRS may conduct a review of cities in one of two broad categories; compliance checks or examinations.

A. Compliance checks

The IRS conducts examinations, also known as audits, authorized under Section 7602 of the Internal Revenue Code. as a review of a taxpayer’s books and records to determine tax liability, and may involve the questioning of third parties.

Compliance checks, which the IRS describes as a review to determine whether an organization is adhering to recordkeeping and information reporting requirements and is not an examination since it does not directly relate to determining a tax liability for any particular period, often involves 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. An officer or representative of an exempt organization may refuse to participate in a compliance check without penalty. However, it is important to note the IRS has the option of opening a formal examination, whether or not the organization agrees to participate in a compliance check.

B. Examinations

Alternatively, review activity may consist of an examination at the city operation. The IRS describes these audits as the most comprehensive.
field examination typically concludes with a closing conference. The revenue agent will discuss the audit with the organization’s representatives, and if necessary, furnish a report explaining proposed adjustments to the organization’s returns or exempt status. If the revenue agent and the organization’s representatives disagree on the findings, the organization may request a meeting with the revenue agent’s manager to discuss the disagreement. If the manager cannot resolve the differences, the organization may pursue its case through the IRS appeals process. 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, the recipient is responsible for adequate accounting of the expenditure within a reasonable time, and any excess reimbursements are returned to the employer. If the requirements of an accountable plan are not met, the reimbursement is considered 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.

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. In the Webinar on Travel reimbursement policies, the IRS explains traveling “away from home” (webinar is linked to the left, means the employee’s destination must be a substantial distance from the workplace and the employee needs to obtain substantial sleep or rest to meet the demands of the work while away from home. IRS Revenue Rulings 73-529 and 93-86 indicate the tax home includes the entire metropolitan area; therefore, the taxpayer is not away from home unless he or she leaves the metropolitan area.

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.
- 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.

An example provided within the IRS webinar on travel reimbursement policies illustrates how the IRS will interpret de minimus with respect to meal expenses for no over-night stay travel.

If city employees or elected officials are out of town for a day meeting, with no over-night stay, and a lunch meal is charged to their city credit card, is this a taxable benefit or is it considered de minimus?

Since this is not an over-night trip the meal would be a taxable fringe benefit to the employee unless the employee reimburses the employer the cost of their meal. If they don't reimburse the employer then the cost of the meal should be included in the employee's wages as a taxable fringe benefit.

It should be noted that it doesn't make any difference how the meal was purchased; the taxability to the employee remains the same.

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 2015 and 2016, a person can contribute up to $3,350 for self-only coverage or $6,650 for family coverage in 2015 and $6,750 for 2016 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.

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.
- Qualified specialized utility repair truck
- An ambulance or hearse used for its specific purpose.
- Any vehicle designed to carry cargo with a loaded gross vehicle weight over 14,000 pounds.

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.

(2) Clothing reimbursements

With a few exceptions, OSHA requires employers to pay for personal protective equipment (PPE) to comply with OSHA standards. The specific clothing employees are required to wear depends on the nature of the workplace. Generally, uniform items are not considered PPEs but can serve a dual purpose of identification as well as helping keeping employees safe by assisting with prevention of some injuries.

There are a number of cities that do allow for a clothing reimbursement or clothing allowance. However, the city will want to be attentive to the taxability issue for employee uniforms. 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 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.

Police officers and firefighters, who are members 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.

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.

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.

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**

Some cities mistakenly think an individual is an independent contractor when in fact the individual should be an employee. Now is the time to ensure any of your independent contractor positions are correctly classified. The legal determination of whether a worker is deemed an employee or independent contractor can have far-reaching financial ramifications for the city, including, but not limited to, workers compensation liability, unemployment insurance penalties, Fair Labor Standards Act obligations, pension and insurance benefits, wrongful termination lawsuits, and vicarious liability to the city for these worker’s negligent actions.

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.

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) **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.
(7) 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 2014. More information about these exclusions can be found in the section Exclusion for Firefighters and Emergency Responders on the IRS web site.

(8) Undeliverable W-2s

When mailing W-2s to employees, sometimes a city will find a mailing for a former employee is returned to the city due to an incorrect address. In cases where there is no forwarding address for the former city employee, the IRS provides the following directions:

Undeliverable Forms W-2. Keep for four years any employee copies of Forms W-2 that you tried to but could not deliver. However, if the undelivered Form W-2 can be produced electronically through April 15th of the fourth year after the year at issue, you do not need to keep undeliverable employee copies. Do not send undeliverable employee copies of Forms W-2 to the Social Security Administration (SSA).

Additionally, the IRS provides this option for undeliverable W-2s:

The city may take the mailing to the post office and for an additional fee (generally approximately $1.35) request a “Certificate of Mailing” to show evidence the mailing was sent. Quoting USPS, “This official record shows the date your mail was accepted.”

Practically speaking, in order to try to find a current address for the former employee, cities may also want to consider checking on line and with other employees or former neighbors and document the attempts made to contact the employee.

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.
## Appendix A: Top IRS Audit Issues

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<th>BENEFIT and links</th>
<th>TAX ISSUE</th>
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| **Athletic and Fitness Facility Memberships**  
26 U.S.C. § 132. | A city may only exclude the value of an employee’s use of a gym or fitness facility owned by the city if substantially all use of the facility during the calendar year is by employees, spouses, and dependent children. This exclusion does not apply to an athletic facility for resident use.  
Example 1: The city has an athletic facility that is open to the public but gives employees a free membership. Because the athletic facility is primarily for public / resident use, the value of the membership is taxable income to the employee.  
Example 2: The city offers a fitness facility that is only accessible to employees. The employees’ use of the facility is non-taxable because only employees are able to access the facility and there is no use by the general public.  
Keep in mind if the city is paying for employees' membership to a local gym that is not owned and operated by the city (the employer), the membership is considered a taxable fringe benefit, the value of which should be included in the employee's W-2. |
| **Car and Clothing Allowance**  
Many cities provide a car allowance for certain employees (e.g. $500 per month for the city administrator). That allowance is taxable income to the employee unless the use is for business and the allowance is provided under an *accountable plan*. |
| IRS: Notice 2016-79. | **Mileage Reimbursement**  
Allowable mileage-rate reimbursements for business travel are excludable from the wages of the employee if paid at or below the standard federal mileage rate. The employee must follow the accountable plan rules and account for the business miles driven.  
If the employer's reimbursement rate exceeds the standard rate, the excess amount is taxable to the employee as regular wages. When there is an excess reimbursement, the nontaxable and taxable amounts are reported on the W-2 form. |
| IRS: Publication 15-B (2017),  
If the city reimburses an employee's mileage under an accountable plan substantiating the business mileage, and the reimbursement is at or below the federal mileage rate, then:

- The reimbursement is not taxable to the employee.
- There is no income tax withheld.
- There is no reporting required on the W-2 form.

### Uniforms

Any allowance provided by the city to employees to purchase clothing or uniforms is considered taxable income unless they are (1) specifically required as a condition of employment, (2) not work or adaptable to general usage as ordinary clothing, and (3) the allowance is provided under an **accountable plan**. (This includes uniforms for police officers.) Safety gear, is usually considered tax exempt as a working condition fringe benefit. Cities can visit the OSHA website for a description of what is considered necessary safety wear for certain duties/conditions.

### Clothing Reimbursement

To be provided under an **accountable plan**, the employee needs to substantiate the date, time, place, etc. of the expense and would need to return any excess amounts to the city. In cases where the allowance (car or clothing) is provided to employees without regard to documentation or requiring excess amounts be returned, the allowance is taxable income, and subject to income, social security and Medicare taxes.

Sometimes cities will ask how to treat uniform allowance for positions, such as detectives who are permitted to wear non-uniform clothing. The IRS has provided guidance that the purchase of a suit jacket and related clothing, since they are suitable for everyday wear, will not qualify as a uniform and, as such, are taxable to the employee.

### Employer Provided Vehicles

Use of an employer-provided vehicle could be taxable income to the employee unless the type of vehicle and usage of such vehicle meets strict requirements.

All of an employee’s use of a qualified non-personal-use vehicle is excluded from the employee’s taxable income. No substantiation of business versus personal use is required. A qualified non-personal-use vehicle is any vehicle the employee is not likely to use more than minimally for personal purposes because of design (e.g. clearly marked police and fire vehicles, unmarked vehicles used by law enforcement officers if the use is officially authorized, etc.).

If an employee uses a city-owned vehicle more than minimally for personal use, then the value of the employee’s business use is not taxable provided the business use can be substantiated.
If the business use cannot be substantiated (in other words, it cannot be determined what use was personal and what use was business), the entire value of the car usage is taxable income to the employee.

To avoid the entire value of the usage being considered taxable income, the city should keep vehicle use logs in every vehicle. Vehicle use should be substantiated to account for mileage, business purpose, and employee identification. If an employer owned vehicle is in the possession of an employee most of the time, that is the employee takes the vehicle home overnight, the employee is responsible for documenting business and personal use. Lack of substantiation is presumed to be personal use. The IRS suggests employers should support a “no personal use policy” included in an employee handbook and be able to show that that policy is enforced by securing vehicles onsite in secure areas and having secure and documented access to keys and vehicles such as a sign-out system, request for use, or some other procedure in place. The amount that can be excluded is the amount that would be allowable as a deductible business expense if the employee paid for its use.

**Gift cards**

Gift cards have become an increasingly popular way to recognize employee achievements through employee recognition events or to reward employees for participating in or completing a wellness event or program. Gift cards are considered to be the same as cash, regardless of the amount. Therefore, the amount of the gift card an employee receives is considered taxable income. The amount of the gift card does not matter (e.g. $5.00 coffee card would still be taxable).

For federal income tax purposes, most prizes and awards are considered taxable fringe benefits subject to federal income and employment tax withholding. Gift cards are the equivalent of cash and should always be included in taxable wages regardless of amount. Certain items can be excluded from wages if they are de minimis in nature. However, cash equivalents are never considered de minimis.