IRS Audit of School Districts

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School Districts Target for IRS Payroll Audits

- School districts are becoming an increasingly popular target for IRS payroll audits.
- In the past, the IRS audits of school district have focused on whether compensation was properly reported to the government.
- The IRS is now looking at much more.
- The presenters will explain what triggered the IRS audit and what to do to limit your exposure to potential IRS audits.

School Districts Target for IRS Payroll Audits

- Why are is the IRS doing audits?
  - Money (withholding federal income, Social Security, and Medicare tax plus interest and penalties)
  - Non-compliance
- Why would they choose our district to audit?
Manitowoc Public School District was Audited

- Back in 2009, the IRS came to audit the Manitowoc Public School District.
- What triggered the audit?
  - The IRS was here because we issued a W-2 and 1099 for an individual in the same calendar year. It looked like they found a problem.

- What did the IRS do first?
  - The IRS had us fill out a 18 page document titled “FSLG Examination Questionnaire”
  - The IRS compliance efforts were generally focused on employment tax and information return reporting because school district are generally exempt from federal income tax

- What does the IRS look at?
  - Are completed (name, address, TIN, type of entity) and signed Forms W-9 secured from all contractors prior to the work being performed or prior to payment for services rendered?
  - How do you determine who receives a Form 1099?
  - Who determines and what criteria are used to determine whether a worker should be treated as an independent contractor or employee?
Manitowoc Public School District was Audited

What does the IRS look at?

- Does the district engage the services of former employees? If so, are they treated as employees or independent contractors?
- What employee fringe benefits does the district provide?
- What classes of employees receive what benefits?

What did the IRS look at?

- IRS reviewed the purchased services basically object 310s.
- IRS asked for an electronic file of all the object 310 expenses in the past two years. They reviewed the list of vendors and compared with the list of W-2 employees.

The District had a former employee that was issued a 1099 and W-2.

- Good news we had a independent contract for the former Director of Pupil Services.
- The IRS found no violations with the 1099s and W-2s.
Manitowoc Public School District was Audited

What did the IRS also look at?
- The IRS agent asked for all employment and post employment plans including copies of contracts of teachers, administrators, clerical, teacher aides and custodial.
- The IRS agent reviewed any non-taxable benefits
- The IRS reviewed post employment benefits

Did they find a Problem?
- Yes, it related to having a choice of cash versus a non-taxable benefit
- Vendor stated that they have done this in other districts and they have an IRS letter ruling
- Vendor stated that the IRS will accept the Health Reimbursement Arrangement (HRA) plan with no problem

What happened next?
- The vendor that set up the plan backed off on any help or guidance
- I hired a lawyer and from then on all the correspondence was through the lawyer
- The IRS felt the District had under paid social security, Medicare and federal withholding and thus, the IRS was going to charge $19,908 plus interest and penalties.
Manitowoc Public School District was Audited

What happened next?

- I discontinued the Health Reimbursement Arrangement (HRA) to stop any more IRS violations.
- Corrected the Health Reimbursement Arrangement (HRA) for the current year (not under review because not finished)
- Informed the IRS of such changes for the year

- The IRS until it was finally settled occurred about 3 years from the first correspondence
- The District and legal counsel were able to reduce the final settlement charges to $8,262 with no interest or penalties
- Legal cost were just under $10,000 because of the length of the settlement or about $2,000 in less cost to the District

Freedom Area School District was Audited

- Our first communication was on February 4, 2016. Our employment tax returns for 2014 were selected for examination.
- This was the Quarterly Federal Tax Returns.
- The first questions they asked were for our employee handbooks in place in 2014 and all employment contracts with school district administration.
- Also as part of the exam they wanted to review accounts payable detail for the calendar year 2014.
- With this they also asked for a chart of accounts.
- The same time they also asked for payroll detail showing all sources of income as well as deductions to reconcile the 941's and finally a copy of our W-3 from that year.
- We complied quickly with answers to all the questions.
Freedom Area School District was Audited

- It only took a few days for follow up questions to come, February 26, 2014.
- The first ones related to our details on our payroll.
- That same day questions came regarding our early retirement and sick leave payouts for 2014. They also wanted to know who retired and how much accumulated sick they had.
- Questions related to 1099’s then began. We sent 1099’s to vendors they didn’t know if we should have. They asked for specific invoices to be sent.
- They questioned employees using a 403(B) catch up provision.
- We answered. Then we waited again.

Freedom Area School District was Audited

- Our next set of questions came on March 14, 2016.
- They asked for more documentation on our annual payroll.
- Then came the issues. A check was issued to Business Manager for reimbursement for anniversary gifts.
- There were volunteer coaches who received 1099’s as the money was coming from a student activity account. They questioned whether they should be our employees.
- In the sampled transactions were payment to STEP individuals. They asked further questions and clarification as well as included a copy of a previous IRS ruling related to the STEP program. They questioned why we did not consider and treat them as employees.

Freedom Area School District was Audited

- Each of those three issues resulted in a finding.
- First issuing gift cards. That should have been taxable income to our staff. As it was excluded from their gross income we were charged the social security and federal tax for this amount.
- Gifts were $2,080 we were charged a total of $830.18 on this finding.
- When given a chance to speak with the auditor we talked about other options for those gifts. His response was anything that can not easily be turned into cash is ok. We quickly establish embroidered gifts for the various anniversary levels for our staff.
**Freedom Area School District was Audited**

- The second big issue had to do with job reclassifications.
- First was the "volunteer" coaches that were being paid from the student activity account. While we sent them 1099's the IRS felt they were employees and needed to be treated as such.
- We still allow the student activity account to reward these volunteer coaches but that amount is now paid through payroll. The student activity account also pays the social security and WRS (if applicable) for these people.
- Second was the STEP volunteers. Due to the IRS letter ruling we decided to disband our STEP program.
- These two findings resulted in social security and taxes being due. The amount error they found with these two situations was $11,137.87 and the taxes due were $1,189.52.

**Freedom Area School District was Audited**

- The audited ended with an exit conference with the auditor. I was able to ask him questions about the findings. He gave very generic answers to many of them.
- I also had to sign two agreements. Each of these agreements concluded that the only time in question would be what they looked at. We could continue operating as we had until June 30, 2016. Which allowed us to complete the STEP program for last year. After this time though we had to change our ways. Which we have done.
- No more STEP program
- New Anniversary incentives for staff
- All volunteers being paid through payroll.

**Freedom Area School District was Audited**

- IN CONCLUSION for Freedom ....
  - All in all I felt our process was fairly painless and short. We were finished with the entire process within four months.
  - He could have asked to look back and ahead three years from the year he looked at. We were grateful he did not do that.
What did we learn?

- When the IRS comes knocking on your door assign one person to be the lead on the investigation.
- Give them everything they ask for as quickly as possible. Do not hold anything back.
- Use the opportunity to ask questions along the way.
- Be thankful that was all they found! We all know there are things we could be doing better.

What should you do?

- Go back to your office and check for these hotspots.
  - Giving 1099's and W-2's to employees.
  - Are you giving 1099's to people whose work you really do direct and should be considered employees?
  - Review your STEP program. Is this a time to reconsider this program? Should you add these volunteers as employees and follow those rules?
  - How are you recognizing your staff? If giving cash alternatives are you adding this to their taxable income? Should you go a different direction with your gifts?
  - Do you give your staff an option of cash versus non cash benefits? If so are you running that through a proper arrangement?

Are there any questions?
Thank you for coming today!