



Sue W. Yount
Partner

Columbus
614.227.2336
syount@bricker.com

IRS audits: 1099s and retirement plans

July 1, 2016

Just a few years ago, Internal Revenue Service (IRS) audits of public school districts were something that school officials never heard about, but now we have seen several in Ohio. An IRS audit is time-consuming and stressful and can result in penalties. While there is nothing you can do to avoid an audit, keeping your office compliant with all relevant federal tax reporting obligations will help ease the pain and lead to a favorable resolution of the audit process.

Rules for 1099s

One area of increased concern is a school district's responsibility to issue a Form 1099 to certain vendors. To properly identify the transactions that will require your school district to issue a Form 1099, there are a few basic rules to keep in mind.

The general rule is that a public school district must issue a Form 1099 for transactions in which the aggregate payment equals or exceeds \$600 and qualifies as one of the following: (1) salaries, wages, commissions, fees and other forms of compensation for services; (2) interest, rents, royalties, annuities, pensions and other gains, profits and income. There are, however, a number of important exceptions that limit the scope of the general rule. One exception, and perhaps the most obvious, is that school districts should not issue a Form 1099 to service providers that qualify as employees for federal tax purposes. Furthermore, a school district is

not required to issue a Form 1099 when paying bills for merchandise, unless the merchandise is merely incidental to a service that is being provided to the school district. While these are the two most important exceptions, please note this is not an exhaustive list.

Outside of the basic rules on Form 1099 reporting, there are numerous other complications to consider. For example, where a school district uses a credit card to make a payment that would otherwise be subject to Form 1099 reporting, the school district generally will not have to issue a Form 1099. For a complete analysis of all the intricacies and exceptions surrounding section 6041 of the Internal Revenue Code (IRC) and Form 1099 reporting, please consult with your district's legal counsel who regularly works on tax issues or your district's tax advisor.

Audits of 403(b) and other retirement plans

Increased IRS audit activity on 403(b) and other school district retirement plans (including 457 plans, 401(a) plans and money purchase plans) is another issue for which school districts should be on high alert. In recent audits, the IRS has discovered school district 403(b) plans are not in compliance with IRC rules and regulations, leading to increased scrutiny.

Two particular points of interest for the IRS are contributions in excess of IRC dollar limits (e.g., contributing \$70,000 in a single year) and the contribution of accumulated but unused sick and vacation leave (and any other contributions such as performance incentives) at retirement. School districts need to be aware that small violations of IRC rules can lead to large tax and penalty consequences for both the school district and contributing employees.

For example, if a superintendent (or any employee) contributes unused sick or vacation leave to a plan incorrectly characterized as an "employer contribution" instead of an "elective deferral," the contributing employee will be faced with double taxation, interest and penalties. Double taxation and interest alone can subject the contributing employee to paying over 80 percent of such earned amounts to the IRS, with additional penalties possible. The school district itself can face large penalties from the IRS in order to return its plans to IRC compliance (along with additional legal and accounting fees). Specific language detailing accumulated leave contributions must be in both employment contracts and plan documents. It is possible that the plan documents provided by plan administration vendors are lacking in such required language or that the language has not been modified to accurately reflect plan administration practices.

In addition, while retirement plan vendors should have controls in place to catch contributions in excess of IRC dollar limits, many do not carefully monitor the IRS limits, leaving school districts and employees with the burden of dealing with IRS penalties. We have seen instances in which a vendor permitted contributions for a single year that were more than double the IRC dollar limits without any red flags

being raised or the school district being notified. During an IRS audit (which, initially, is typically for a single plan year), if the IRS discovers even a minor contribution error for a single employee/former employee, the IRS auditor will likely open up other years to audit as well. This expansion of the audit then leads to additional time for you and your staff dealing with auditor requests, which can lead to many more errors being discovered.

All documents regarding 403(b), 457 and any other retirement plan contributions, including employment contracts, board policies and the plan documents themselves, should be reviewed by counsel for IRC compliance. Past contributions should also be reviewed to determine whether any such contributions violated IRC limits.

The IRS may audit your school district's 1099s, retirement plans, payroll withholdings, compliance with the Affordable Care Act (ACA) or other matters. Continued diligence on compliance and obtaining high-quality assistance on these matters will help you avoid a time-consuming and stressful audit.