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March 30, 2010

The Honorable Jonathan Nowaczek
Mayor, City of Bayport
294 North Third Street
Bayport, Minnesota 55003

Dear Mayor Nowaczek:

The Office of the State Auditor (“OSA”) received concerns about the City of Bayport’s use of forfeited medical “flex plan” funds to pay a portion of the expenses for a retirement party held in October 2009 for an independent contractor, former City Administrator Mike McGuire.

Based upon the OSA’s review, it appears:

- The City had no authority to use forfeited medical “flex plan” funds to pay for a retirement party.
- The City had no authority to expend public funds for the retirement party held for the former City Administrator, an independent contractor.
- The City failed to adopt a resolution for donations received by the City.

On April 30, 2005, former City Administrator McGuire resigned from his City Administrator position with the City.¹ Within 30 days of his resignation date, the City rehired Mr. McGuire as an independent contractor for the same position.² In July 2009, the City Council accepted a letter submitted by Mr. McGuire resigning from his independent contractor position with the City.³ Mr. McGuire attended his last formal City Council meeting on October 5, 2009.⁴

The City held a retirement party for Mr. McGuire after normal business hours on October 28, 2009, at a City-owned beach house. The event included catered food and a cash bar.

¹ See *In the Matter of the Application for PERA Retirement Benefits of Michael A. McGuire*, Minn. Ct. App., A07-2066, p. 2 (October 7, 2008).

² *Id.* at 2 and 6.

³ See City of Bayport Meeting Minutes (July 6, 2009). The minutes refer to termination of a contract with McGuire Management Services.

⁴ See City of Bayport Meeting Minutes (October 5, 2009). According to the minutes, new City Administrator Mitchell Berg began his employment on October 26, 2009, and there was a two-week training period with the current administrator.

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The City invited the public to attend by providing notice of the party in the newspaper and in the City Council meeting minutes.⁵ The announcement noted that contributions toward a City park bench in honor of Mr. McGuire could be sent to City Hall. The City estimated that 50-100 people attended the event.

City expenses for the retirement party totaled approximately \$798.40.⁶ More specifically, it appears that the City used \$608.25 in forfeited flexible medical spending funds to pay most of the catering bill, including a “Bar Set-Up” fee of \$125.⁷ The City also used approximately \$50 in excess park bench donations and approximately \$140 from the City’s General Fund to pay for the party.⁸

Use Of Forfeited Medical “Flex Plan” Funds

Internal Revenue Service (“IRS”) regulations provide that unused medical “flex plan” funds in an employee’s account at the end of the year must be forfeited to the employer.⁹ According to proposed IRS regulations, an employer may retain the forfeited funds or use the funds for limited purposes related to the benefit plan.¹⁰ Specifically, the employer may 1) use the forfeited funds to reduce the plan participants’ salary reduction amounts for the following plan year; 2) use the forfeited funds to defray the expenses the employer incurred to administer the plan; or 3) return the forfeited funds to the plan participants on a reasonable and uniform basis.¹¹

⁵ See City of Bayport Meeting Minutes (October 5, 2009).

⁶ The City’s expenses for the retirement party included catered food and services, equipment rental, paper for invitations, postage, paper plates and napkins, a photograph, picture frame, brass plate, and a bench plaque. The City also contributed use of the beach house facility and the cost of utilities.

⁷ The City informed the OSA that in 2008, an employee did not use the money in a medical “flex plan” account by the year-end deadline. As a result, the money was forfeited to the City and maintained in the City’s General Fund. According to the City, this was the only time “flex plan” funds were forfeited to the City, and no current City employees have “flex plan” accounts that terminate at year-end. According to the City, Mr. McGuire consulted with the City’s insurance provider and the City Attorney regarding the use of the forfeited “flex plan” funds for his retirement party.

⁸ The City reported that it received approximately \$800 in private donations in honor of Mr. McGuire to pay for the City park bench.

⁹ The IRS refers to this type of benefit as a health flexible spending arrangement (“health FSA”). Flexible spending accounts are known as “use-it-or-lose-it” plans. See Internal Revenue Publication 969, “Health Savings Accounts and Other Tax Favored Health Plans” available on the IRS website at:

http://www.irs.gov/publications/p969/ar02.html#en_US_publink10000204174.

¹⁰ See Internal Revenue Bulletin 2007-39 (September 24, 2007) (REG-142695-05), Section 1.125-5 (o), found on the IRS website at: http://www.irs.gov/irb/2007-39_IRB/ar14.html. According to the proposed rules, taxpayers may rely on the proposed regulations for guidance pending the issuance of final regulations.

¹¹ *Id.* The League of Minnesota Cities has also issued a memorandum entitled, “Navigating Flexible Benefit Plans” available at: <http://www.lmnc.org/>. On page 2, the memorandum notes that cities may use any remaining amounts under the “Use-It-or-Lose-It Rule” to offset their risk and any administrative costs associated with offering the plan.

The OSA knows of no authority for the City to use forfeited “flex plan” funds for a retirement party. The OSA recommends that the City contact the IRS to determine how to resolve this matter.

City Funded Party For An Independent Contractor

For a city’s expenditure of public funds to be valid, the expenditure must be for a public purpose and authorized by statute. Since 2007, cities have been authorized to establish and to expend public funds on a wellness and employee recognition program.¹² This authority, however, does not extend to recognition events for independent contractors or other City vendors.

In addition, properly established wellness and employee recognition programs should be in writing and approved by the city council. The City informed the OSA that it does not have an employee recognition policy. Despite the lack of such a policy, the City informed the OSA that it has used City funds during the past six years to honor public officials and management-level employees who were retiring or leaving service with the City.¹³

Public entities may not pay for spouses or third parties to attend recognition events. The City reported that the retirement party attendees included two or three City employees, City Council members, invited guests, members of the public, and Mr. McGuire and family members. Among the invited guests were former Bayport mayors, Planning Commission and Library Board members, and city administrators and elected officials from other communities in the area.

Finally, the expenditure of public funds to purchase alcohol is not permitted. However, the catering bill paid by the City included “set-up” fees for a cash bar.

The OSA knows of no authority for the City to expend public funds for a retirement party for one of the City’s independent contractors. The OSA knows of no authority for the City to pay for the attendance of spouses or third parties at such an event, or to pay the costs associated with the purchase of alcohol.

¹² Minn. Stat. § 15.46 provides that a city “may establish and operate a program of preventive health and employee recognition services for its employees and may provide necessary staff, equipment, and facilities and may expend funds as necessary to achieve the objectives of the program.” For more information on employee recognition events, a copy of the OSA’s Statement of Position on “Employee Recognition Programs and Events” is enclosed. The Statement of Position is also available at the following link: http://www.auditor.state.mn.us/other/Statements/employeerecogprogevents_0705_statement.pdf.

¹³ The City told the OSA that it typically gave the honoree a plaque worth approximately \$50.

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The OSA recommends that the City establish a written employee wellness and recognition program. The OSA also recommends that all City expenditures be for a public purpose and comply with Minnesota law.

Donations Received By The City

Minnesota law allows a city council to accept gifts on behalf of a city in accordance with the terms set forth by the donors. However, gifts must be accepted by a resolution approved by a two-thirds majority of the council.¹⁴

The City solicited and accepted private donations on behalf of Mr. McGuire for a City park bench. The City Council did not pass a resolution accepting the donations.

The OSA recommends that the City comply with Minnesota law and adopt resolutions when accepting donations.

Conclusion

The OSA knows of no authority for the City's expenditures for the retirement party the City held for its former City Administrator.

If you have any questions, please feel free to contact me at (651) 297-7108 or by email at Terrilyn.Diamond@state.mn.us.

Sincerely,

/s/ Terrilyn Diamond

Terrilyn Diamond
Attorney
Office of the State Auditor

Enclosure

cc: Mr. Mitchell Berg, City Administrator
Mr. Andrew Berg, Abdo, Eick & Meyers LLP, City auditor
Ms. Ursula Elbert-Booker, Internal Revenue Service

¹⁴ Minn. Stat. § 465.03.



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Statement of Position Employee Recognition Programs and Events

Local units of government often ask whether they can spend money to hold holiday parties, employee banquets or other employee social events. These questions appear to be motivated by a desire to celebrate a holiday or significant event in an employee's life or to generally boost morale in the workplace. Important limitations exist on the use of public funds for employee social and recognition events.

The key question is whether a local government has legal authority for this type of spending. Generally, in order to spend money, a local government must have authority to do so. Authority for an expenditure may be specifically stated in a statute or charter, or it may be implied as necessary to do what an express power authorizes.

The Minnesota Attorney General's Office has considered the issue several times and has consistently said that local governments do not have implied authority to sponsor employee social events simply because they have the express power to compensate employees.

Instead, the Attorney General's position is that non-monetary benefits must be specifically authorized by law or charter. Based on this rationale, [the Attorney General's Office wrote to the Champlin city attorney in 1998](#), indicating that no statutory authority existed for a city to hold an annual employee appreciation dinner or to award employee recognition gifts to employees. The Attorney General's Office stated: "[W]hile an agreed upon monetary bonus might be provided as part of a salary plan to employees who meet performance or longevity standards, we are at a loss to locate authority for expenditures of funds for in-kind awards or social occasions of the type described."

Limited Statutory Authority Granted to Counties and Cities

Counties and cities do have specific authority for a wellness and employee recognition program under Minn. Stat. § 15.46. This statute states that a county or a statutory or home rule charter city "may establish and operate a program of preventive health and employee recognition services for its employees and may provide necessary staff, equipment, and facilities and may expend funds as necessary to achieve the objectives of

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the program.” Cities were added to the statute in 2007. This statute does not currently extend to other local units of government.

Properly established programs should be in writing and approved by the county board or city council. They should include clear wellness and recognition objectives. The county board or city council must determine what amounts can be expended as “necessary to achieve the objectives of the program.”

The Office of the State Auditor, in reviewing county or city expenditures for wellness and employee recognition programs, will be guided by what is permitted and what is prohibited for state employees. Counties and cities cannot simply provide employee banquets or parties for all employees. County and city funds can be spent only as necessary to achieve the objectives of an established wellness and employee recognition program. The public entity may not pay for spouses or third parties to attend a recognition event. In addition, expenditure of public funds to purchase alcohol is not permitted.

Towns Have Specific Statutory Authority

Towns are not mentioned in section 15.46. However, the 2008 Legislature granted town electors the authority to set an amount of money for the town board to spend recognizing “volunteers, service efforts and retiring town officers.” The statute specifically requires the electors to set the amount of money to be spent on these recognitions. Absent such a vote by the electors at an annual or special meeting, towns do not have authority to hold employee recognition events.

School Districts Have Separate Specific Authority

A school board may establish and operate an employee recognition program for district employees, including teachers, and may expend funds as necessary to achieve the objectives of the program. The employee recognition program shall not include monetary awards.¹

¹ See Minn. Stat. §123B.02, subd. 14a.