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Correspondence Memorandum

Date: February 23, 2017
To: Audit Committee
From: Yikchau Sze, Director
Office of Internal Audit
Subject: Withholding Tax Reporting and Payment Audit

This report is for Audit Committee review and discussion. No action is required.

Attached is the audit report of the Withholding Tax Reporting and Payment audit. The results of this audit have been submitted and discussed with the Office of the Secretary, Department of Employee Trust Funds (ETF).

This audit was conducted in accordance with the biennial Audit Plan for 2015-2017.

The objective of this audit was to assess ETF's withholding tax reporting process to ensure that adequate internal controls are in place for accurate and timely reporting of withholding tax to federal and state tax authorities.

We evaluated the design and operating effectiveness of key controls that were in place from April 1, 2016 to June 30, 2016. No material issues were noted, although we offered one recommendation for management's consideration.

Attachment: Audit Report of Withholding Tax Reporting and Payment

Reviewed and approved by Robert J. Conlin, Secretary

Electronically Signed 3/3/17

Board	Mtg Date	Item #
AUD	3.23.17	5A

Office of Internal Audit

Tax Reporting and Tax Payment-Withholding



January 19, 2017

Objective:

The audit objective was to assess the Department of Employee Trust Funds (ETF) withholding tax reporting process to ensure that adequate internal controls are in place for accurate and timely reporting of withholding tax to federal and state tax authorities.

Scope:

The audit scope focused on the withholding tax reporting process in place from April 1, 2016 through June 30, 2016, and the accuracy of the 2015 year-end tax filing.

Background:

Highlights of Internal Revenue Code

The Wisconsin Retirement System (WRS) is a qualified annuity plan for federal income tax purposes. Distributions of annuity payments and lump sum payments (LSP) must be treated as if they were wages paid by an employer to an employee and are subject to wage withholding tax under the Internal Revenue Code (IRC). As the plan administrator, ETF must maintain and administer the WRS in compliance with the IRC. ETF is responsible for collecting withholding tax for annuity and LSP payments, paying withholding tax to the Federal and State government, and keeping records of the taxes withheld and paid. ETF must deposit the tax payment by the next banking day after the date of distribution, as ETF falls under the \$100,000 Next-Day Deposit Rule (Publication 15 – Chapter 11 Depositing Taxes).

ETF is required by the IRC to issue a 1099-R for taxes withheld for the recipients of annuities and LSPs residing in the United States and when the withheld amount is greater than \$10.00. ETF must file an *Annual Return of Withheld Federal Income Tax*, Form 945, with the Internal Revenue Service (IRS), and a 945-A indicating ETF's tax liability for each day in the year by the end of January, for the prior year. Total liability on Form 945 represents total withholding tax that ETF is responsible for paying the IRS and should equal the aggregate amount of 1099-Rs issued for the year. If the total amount of the 1099-Rs exceed the amount reported on Form 945, additional tax is owed to the IRS, and the IRS may charge interest and/or a penalty for late payment.

For the recipients of annuities and LSPs who reside outside the United States and are not citizens (nonresident aliens), ETF is required to retain withholding tax at 30% of

payments if a withholding certificate (W-8BEN) is not received from the nonresident alien. Form W-8BEN is used by a nonresident alien to claim a tax treaty (if applicable) between the U.S. and his/her home country. After receiving the Taxpayer Identification Number and the W-8BEN, ETF could exempt, reduce or increase the withholding tax for the nonresident alien.

IRS tax code holds ETF, as the withholding agent, “personally” liable for any withholding tax required from foreign persons living outside the U.S. and its territories. This liability is independent of the tax liability of the foreign person to whom the payment is made. If ETF fails to withhold the proper amount of tax and the foreign payee fails to satisfy its U.S. tax withholding liability, both ETF and the foreign person are liable for tax, as well as any interest and/or penalties assessed. Regardless, if the foreign person satisfies its U.S. Tax withholding liability, ETF remains liable for any interest and/or penalties assessed based on the taxes it failed to withhold.

At year-end, as the plan administrator, ETF must furnish a statement of *Foreign Person’s U.S. Source Income Subject to Withholding* (Form 1042-S) to each nonresident alien who received funds during the calendar year. ETF is also responsible for filing the *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons* (1042) to the IRS. This 1042 form displays the collective amount and week that withholding taxes were deducted from the recipients. The total on the 1042 form should equal the total of all the 1042-S forms issued for the year, and the payments to the IRS should match the corresponding tax period. If the total amount of the 1042-S exceeds the amount reported on 1042, additional tax is owed to the IRS, and the IRS may charge interest and/or a penalty for late payment.

Past Errors in Tax Reporting and Payments

The following errors have occurred in the past and resulted in interest assessed by the IRS.

- ETF had experienced consistent shortfalls on 945 reporting (total amount of the 1099-Rs issued for the year exceeded the reported amount on 945);
- Department of Administration paid one withholding tax payment to the IRS late by 31 days;

- ETF violated the Next-Day Deposit Rule by one day (ETF self-reported the violation to the IRS);

ETF appealed the interest assessed in each case noted above. The appeal included explaining why the error occurred, documenting the internal controls in place, stating additional internal controls being implemented as well as identifying ETF’s high volume and success rate. ETF won the appeal and thus, did not pay any interest. Although ETF successfully appealed the interest assessed in each case, significant effort and resources were consumed in the process.

In addition to the error noted above, prior to 2015 ETF did not have a good process in place to ensure withholding tax was reported and withheld appropriately for nonresident aliens who receive annuity or LSP.

Improvements Made at ETF

To improve the tax withholding and reporting process, in August 2014 the annuity payroll function was transitioned from the Division of Retirement Services to the Division of Trust Finance (DTF). This change improved segregation of duties and paved the way for centralizing the tax processing and reporting function at DTF. A tax specialist was hired in August 2015 as part of this centralization effort. Significant improvements have been made at DTF since the creation of this centralized tax function. Below are the major improvements that have been made to the tax withholding and reporting process:

<i>New Processes/Controls</i>	<i>Risks Mitigated</i>
DTF staff obtained read-only access to the Electronic Federal Tax Payment System (EFTPS) to verify that the tax payment made by the Department of Administration (DOA) on behalf of ETF was on the correct payment date, for the correct amount, and that it was acknowledged by the Internal Revenue Service (IRS).	Missed or Late Payment; Incorrect Amount; Incorrect Payment Date
Established a reconciliation verification process to ensure that batches of withholding tax submitted to DOA for payment processing was accurate. This was accomplished by developing a calendar spreadsheet to track payment cycle, voucher number,	Incorrect Amount Incorrect Recording

transaction date and dollar amount for both federal (945 and 1042) and state withholding taxes.	
Implemented same-day payment of federal tax liability to provide a “cushion” that ETF would meet the Next-Day Deposit Rule to avoid a late payment penalty, which can be significant.	Late Payment
Implemented a process to monitor 1099-R issuance and compare to total withholding tax paid to the IRS during the year.	Payment Shortfalls
Stopped issuing 1099-Rs for LSPs at the time the LSP was made to avoid conflicting with IRS processing capability. By issuing 1099-Rs in January following the close of the tax year, same-year recovered LSPs due to rollovers, cancelations or other matters could be cancelled in the system without triggering the reissuance of a 1099-R.	Incorrect Reporting and Recording
Implemented a process to identify annuitants living outside of the United States and initiated a direct mailing program to confirm their citizenships and to verify their claimed tax treaties. This process mitigates the risks of withholding an incorrect amount of tax and improper reporting for nonresident aliens.	Improper Withholding Improper Reporting
Improved member privacy by having member Social Security number truncated on the 1099-R	Privacy Concerns

In addition to the above controls, ETF discovered why discrepancies in the past had consistently existed between the aggregate 1099-Rs and the amount reported on Form 945. In 2015 a work group was formed to research and resolve this issue. The work group discovered in January 2016 that withholding tax transactions can be reversed in the Benefit Payment System (BPS) across tax years. Therefore, taxes paid in a prior year were being reversed off the current year tax liability. In June 2016 ETF IT staff reprogrammed the BPS to separate tax year transactions.

Because this cross year off-setting was not corrected until mid-2016, a shortfall of withholding tax payments in comparison to 1099-Rs issued was expected for the 2016 tax year. To mitigate potential interest and/or penalties that could be assessed by the IRS, DTF overpaid withholding tax, in order to cover an estimated shortfall. DTF

documented the methodology supporting the estimate and generated a voucher prior to 2016 year-end to make an “overpayment” of the tax liabilities. It should be noted that any overpayment of withholding tax would be refunded by the IRS in the following year.

Testing:

We conducted this audit by:

- interviewing responsible staff and performing walkthroughs to obtain an understanding of DTF’s process for the federal and state withholding tax reporting and payment;
- researching both federal and state tax laws pertaining to withholding tax for a pension system;
- re-performing reconciliations verification for the 2nd Quarter of 2016;
- testing the accuracy of tax filing of 1042 and 945 for the tax year of 2015; and
- verifying the existence of internal controls for the period tested.

Re-performing reconciliations to validate the accuracy of the calendar spreadsheet

A calendar spreadsheet was created by the tax specialist to ensure that withholding tax batches submitted to the DOA for payment were in agreement with what was processed by the BPS and Lump Sum Payment System (LSPS). The spreadsheet tracks withholding payments by voucher number, dollar amount, liability date and payment date for both federal and state withholding tax processed. This calendar spreadsheet is also used by the tax specialist to compare with 1099-R issued for the year.

We re-performed the reconciliations that the tax specialist is responsible for. We agreed the withholding tax transactions tracked on the spreadsheet to the payment vouchers for both monthly annuity payroll and LSPs. No exceptions were noted.

To ensure that payment vouchers used by the tax specialist for tracking is accurate, we examined payment vouchers for accuracy and proper support for the monthly annuity payroll and the LSPs. The voucher totals appeared to be reasonably supported by the detailed transactions reported by the BPS and the LSPS.

Testing accuracy of withholding tax filed with IRS

We traced each payment on the calendar spreadsheet in the testing period to the deposits settled on the EFTPS system. Every transaction was acknowledged by the transaction log of the EFTPS for correct payment amount and correct payment day.

Testing the accuracy of 1042 and 945 for the 2015 annuity and LSPS transactions

- 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons

We generated a spreadsheet that included all the individuals receiving a 1042-S from ETF for the year of 2015. We validated a sample of individuals on the spreadsheet by vouching to their personal identifiable information. We then examined the withholding tax rate of the selected individuals for accuracy and agreed the withholding tax total amount on the spreadsheet to the total reported on Form 1042 for 2015. No exceptions were noted.

- 945, Annual Return of Withheld Federal Income Tax

For the 2015 year end filing of 945, we tracked each annuity and LSP withholding tax processed by the systems and compared the total dollar amount to the amount filed on the 945. We were able to trace and validate a minor difference identified during this testing. No exceptions were noted.

When comparing the 945 to the 1099-Rs issued for the year, we noticed a small shortage. The cause of this shortage was largely due to withholding tax transactions being reversed in the BPS across tax years. As discussed above, the BPS was reprogrammed in June 2016 to stop this cross year off-setting. We verified that discrepancies between 1099-Rs issued in 2016 and 945 reported for 2016 were closely monitored by the tax specialist. We also participated in the discussion and agreed with the “overpayment” strategy to avoid potential interest and penalties for 2016 based on this difference.

Results:

Audit Finding:

Written procedures for the withholding tax reconciliation process have not been developed. Additionally, there is not adequate backup for the tax specialist functions to ensure continuity.

Since joining ETF in August 2015 the tax specialist has led efforts to streamline existing processes and establish new processes and internal controls to mitigate the risk of non-compliance with both federal and state tax reporting requirements. However, documentation of those improved processes and controls is not in place. Because the tax specialist is the only individual that handles this critical financial and compliance function, having well-documented procedures is critical to ensure continuity. In addition, there is no adequate backup and no staff are cross-trained to handle the tax reporting function. This increases the risk of errors which could result in interest and/or penalties assessed by the IRS.

Recommendations:

We recommend that the DTF develop written procedures to document the improved withholding tax process that is currently in place and start cross-training a backup person once the procedures are documented.

Management Responses:

Management will ensure the state and federal withholding tax process is fully documented. Management also recognizes the need for a backup and has requested staffing as part of the Department's fiscal 2017-19 biennial budget request for this purpose. Until additional staffing is approved and hired, management will work with existing staff, to the extent they have capacity, to train and provide backup of essential tax functions.

Responsible staff: Blain Parsons

Completion Date: March 31, 2017

Conclusion:

We evaluated the centralized tax withholding and reporting function. Although we offered one recommendation for management's consideration, we concluded that for the months audited, the key controls were operating effectively and provided reasonable assurance for accurate and timely reporting of withholding tax. In particular, the key

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controls of reconciliation, confirmation of withholding tax payment through the EFTPS, and foreign annuitant withholding tax monitoring significantly reduced ETF's operational and compliance risks relating to withholding tax.