

Assurance Report

1628 Review of Processes Related to Unsheltered Funds (Safe Harbor)

February 2, 2017

Cindy Rougeou, Executive Director
The LASERS Audit Committee

EXECUTIVE SUMMARY

The following observations were noted during this review and are detailed below:

1. The process to identify safe harbor fund errors should be enhanced.
2. The general rule method calculation formula used for safe harbor fund recovery requires review.
3. Safe harbor error correction procedures should be created and all procedures that include safe harbor processing should be reviewed.

Furthermore, there were no safe harbor related issues reported during prior projects performed by Audit Services that have resurfaced.

BACKGROUND

This was a planned engagement on the fiscal year end (FYE) 2016 Audit Plan. The fieldwork for this engagement was completed on December 16, 2016.

Safe harbor amounts occur when retirement contributions are remitted with funds that have already been taxed, also referred to as unsheltered funds. Since the member has already paid taxes on the unsheltered funds, the Internal Revenue Service (IRS) allows the member to recapture those funds tax free when receiving a payment from LASERS (i.e., refund, retirement, etc.). This IRS provision is intended to prevent the member from paying taxes twice on the same funds. Some examples of when safe harbor funds will exist include instances where members pay LASERS with unsheltered funds to:

- Purchase service credit
- Repay a refund
- Transfer service credit from another retirement system

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Furthermore, the properly handling of safe harbor funds by LASERS also ensures that the IRS 1099-R Forms issued by LASERS is accurate.

SCOPE, OBJECTIVES, AND METHODOLOGY

The scope of this engagement includes a review of:

- The various LASERS processes that involves the receipt, recapture, and reporting of safe harbor funds.
- Safe harbor issues previously reported by Audit Services.

The primary objectives of this engagement were to determine if:

- Adequate controls are in place to ensure safe harbor funds are properly processed.
- LASERS is in compliance with provisions in the Internal Revenue Code related to the treatment of safe harbor funds.
- Previously reported issues related to safe harbor funds have been adequately addressed.

Procedures used to complete this engagement included:

- Gathering information from LASERS staff on the processes where safe harbor funds are utilized.
- Using Audit Command Language (ACL) to analyze safe harbor fund data in SOLARIS.
- Investigating possible safe harbor fund exceptions identified during testing.
- Providing Member Services and Fiscal staff safe harbor fund exceptions for validation and correction, where necessary.
- Researching and evaluating related controls, procedures, and policies.
- Conducting other inquiries considered necessary to achieve engagement objectives.

This engagement was conducted in accordance with the Institute of Internal Auditors' International Standards for the Professional Practice of Internal Auditing.

OBSERVATIONS, RECOMMENDATIONS, AND RESPONSES

1. PROCESS TO IDENTIFY SAFE HARBOR FUND ERRORS SHOULD BE ENHANCED

OBSERVATION

Safe harbor funds are applied to member records and validated by various automated and manual processes. The applied safe harbor funds are recovered when payments are issued. The primary automated approach is facilitated through SOLARIS processing. The primary manual approach is through a review and verification approach using documented processing procedures. The primary goal of each method is to ensure that all payments include the appropriate amount of safe harbor funds in the situations where safe harbor funds should be applied. Despite these efforts, there are situations where the following types of errors occur:

- | | |
|-------------|--|
| Scenario 1: | The incorrect amount of safe harbor funds is applied to a benefit payment. |
| Scenario 2: | Safe harbor funds are not applied to a benefit payment and should be. |

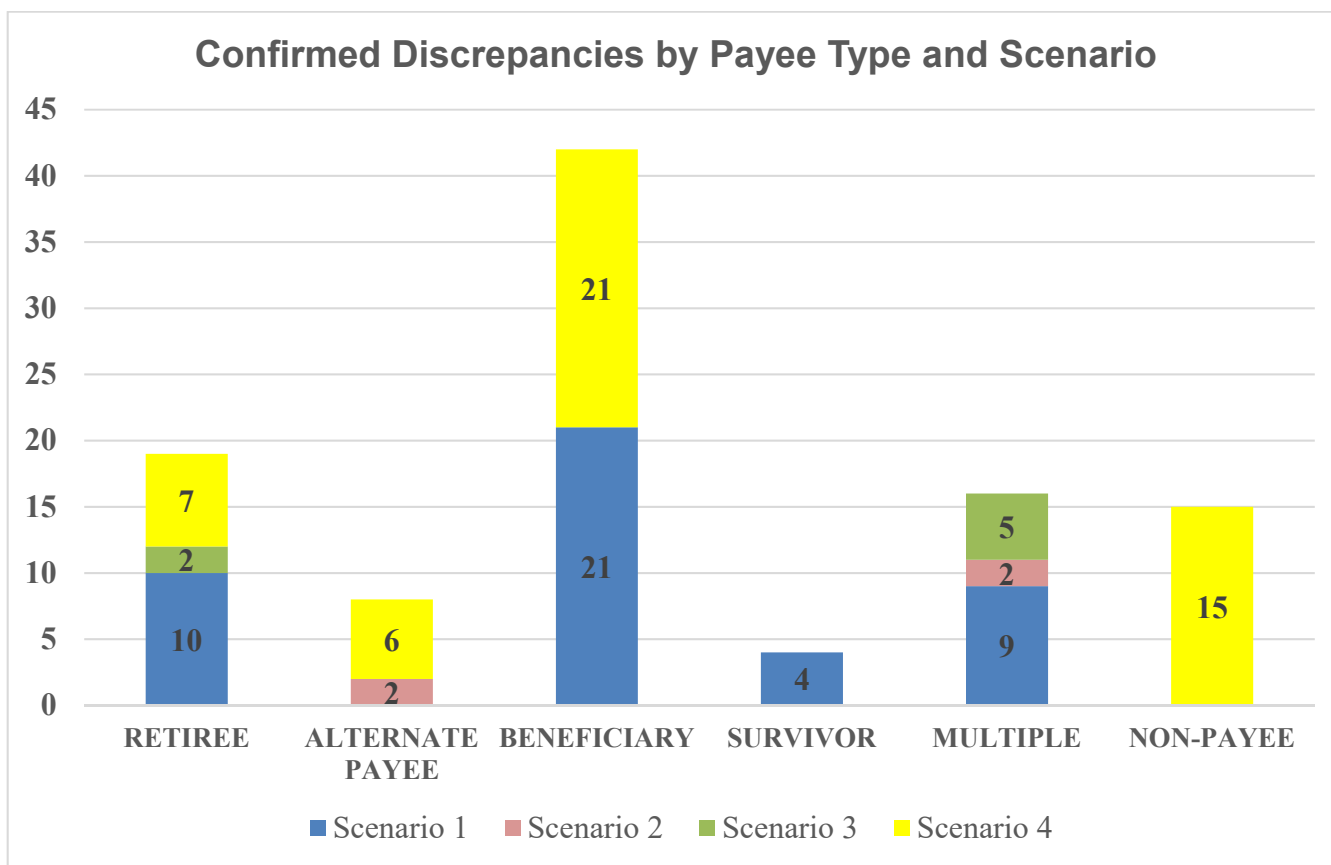
- Scenario 3: Safe harbor funds are applied to a benefit payment and should not be.
- Scenario 4: Data discrepancies between safe harbor data stored in various modules within SOLARIS which do not affect any benefit payments issued.

As an effort to mitigate the impact of these errors, the Fiscal Division runs an annual query toward the end of the calendar year to identify and correct possible safe harbor related errors prior to the issuance of 1099-R Forms. Safe harbor related errors falling into scenarios 1 through 3 can cause the following:

- The taxable income could either be overstated or understated in the year the error occurred and in some cases subsequent years thereafter. It is not possible for LASERS to measure the level of impact to each individual because each person's tax liability is based on many unknown unique and varying circumstances.
- LASERS would be out of compliance with certain Internal Revenue Code (IRC) provisions.

As part of this engagement, Audit Services performed independent testing to ensure that the various established controls were effective at preventing safe harbor related errors and identifying errors in a timely manner and facilitating the appropriate corrective action. The testing focused on validating newly created safe harbor events since January 1, 2014 and covered all types of transactions that includes potential safe harbor activity. This starting period was selected because Audit Services participated in an agency-wide safe harbor project in 2011-2013 which included the review of exceptions. The results of the current testing are outlined in the chart below. It should be noted that some of these items are currently in the process of being corrected. Furthermore, the cause of these discrepancies range from human error, procedure breakdown, and other risks associated with a manual process.

Scenario (as outlined above)	Number of Confirmed Discrepancies
Scenario 1	44
Scenario 2	4
Scenario 3	7
Scenario 4	49
Total	104



RECOMMENDATION #1

Member Services should work with Fiscal and IT to establish a process to effectively identify safe harbor exceptions on a timely basis. The developed solution should include, at a minimum, the following:

- Identify exceptions across all transactions and data where safe harbor related activity can exist.
- Ability to identify exceptions at various points in time (i.e., ad-hoc basis, daily, monthly, annually).
- Consider including the identification of exceptions prior to running monthly pension payroll which would allow for the vast majority of safe harbor related issues to be corrected before impacting the payee's taxable income.

Furthermore, as exceptions are identified, they should be reviewed to determine the root cause of the exception and corrective action taken accordingly (i.e., employee training, system changes, procedure changes).

RESPONSE

Member Services agrees with this recommendation. Member Services plans to take the following corrective action:

- Meet with Audit and Fiscal and gain a better understanding of the logic and methods used to identify the different types of errors that were found.
- Work with IT to implement a Safe Harbor exception report, which will allow us to identify exceptions at any point in time. Member Services plans to run this report one week prior to monthly payroll and review each exception to determine the root cause and take the appropriate corrective action identified.

- Work with Audit to identify any exceptions based on the existing Audit reports while the creation and implementation of the new Safe Harbor exception report is in progress.

Furthermore, IT noted that they plan to work with all related parties to help implement a solution within the timeframe deemed appropriate by the business. The priority to address this recommendation has been set as high with a target completion date of July 7, 2017.

RECOMMENDATION #2

The items noted in the above chart should be corrected.

RESPONSE

Member Services agrees with this recommendation. Corrections have been completed on 94 items and the 10 remaining are in the process of being completed. The priority to address this recommendation has been set as high with a target completion date of May 1, 2017.

2. GENERAL RULE METHOD CALCULATION FORMULA FOR SAFE HARBOR FUND RECOVERY REQUIRES REVIEW

OBSERVATION

The recovery of safe harbor funds is determined using either the simplified or general rule method. Internal Revenue Service (IRS) publications 575 and 939 contain details regarding each of these methods which includes information on how to calculate the recovery amount. The primary method used by LASERS is the simplified method. However, there are situations where the general rule method should be used (e.g., an individual age 75 or over when their benefit begins) per prior guidance received from LASERS specialized tax counsel.

During this review, it was determined that guidance is needed on whether LASERS is using the proper calculation formula when deriving the safe harbor recovery amount under the general rule method. LASERS has received detailed guidance from specialized tax counsel on how to perform calculations using the simplified method; however, detailed guidance on the general rule method has not been received. Improper calculation of the recovery amount will cause the taxable income for those affected to either be overstated or understated in the year the error occurs and in some cases subsequent years thereafter.

RECOMMENDATION

Member Services should work with Legal to evaluate the formula used to calculate the recovery amount under the general rule method. LASERS specialized tax counsel should be consulted as deemed necessary. If it is determined through this evaluation that the formula is in error, then a plan should be established to make the necessary corrections to the affected systems, processes, procedures, and payment records.

RESPONSE

Member Services and Legal agree with this recommendation. Legal has received responses from the specialized tax counsel which answered Member Services pending questions. Member Services plans to take the following corrective action:

- Work with IT to identify and flag the rare instances when a payee should have the Safe Harbor exclusion amount calculated using the General Rule.

- Create General Rule procedures and send to Legal for review and final approval.

Based on the tax counsel response, Members Services has researched and identified that there were no LASERS members/payees who retired since 2014 and should have had the Safe Harbor monthly exclusion calculated using the General Rule. Furthermore, IT noted that they plan to work with all related parties to help implement a solution within the timeframe deemed appropriate by the business. The priority to address this recommendation has been set as medium with a target completion date of December 31, 2017.

3. SAFE HARBOR ERROR CORRECTION PROCEDURES SHOULD BE CREATED AND ALL PROCEDURES THAT INCLUDE SAFE HARBOR PROCESSING SHOULD BE REVIEWED

OBSERVATION

During this engagement, Audit Services reviewed the various desk procedures for both the Member Services and Fiscal divisions that include safe harbor processing. It was determined that formal procedures that outline the steps to correct safe harbor related errors do not exist. Furthermore, suggested updates were provided to both Member Services and Fiscal which were designed to enhance the level of detail and clarity of the procedures that include safe harbor processing and verification steps.

RECOMMENDATION #1

Member Services should work with Fiscal to create cross-divisional procedures to be used when performing safe harbor error corrections.

RESPONSE

Member Services agrees with this recommendation. Member Services will work with Fiscal to document the current cross-divisional procedures used when performing Safe harbor error corrections. The procedures will provide a clear understanding of the responsibilities of each participant. The priority to address this recommendation has been set as high with a target completion date of July 1, 2017.

RECOMMENDATION #2

Member Services and Fiscal should review all procedures within their division that includes safe harbor processing and verification steps and make updates, as deemed necessary.

RESPONSES

Member Services:

Member Services agrees with this recommendation and will update the comprehensive Safe Harbor procedures document, which will provide instructions for all the various processes which calculate Safe Harbor. All process specific procedures will reference the comprehensive Safe Harbor procedures document and provide a link to view the document. The priority to address this recommendation has been set as high with a target completion date of July 1, 2017.

Fiscal:

Fiscal agrees with this recommendation and will update their procedures (i.e., Refunds, Application of Cost Quotes) with regards to safe harbor corrections. The priority to address this recommendation has been set as low with a target completion date of December 31, 2017.

FOLLOW-UP

A follow-up to this engagement will not be scheduled at this time. Audit Services will maintain this information on a tracking report. These items will be tracked until they are closed.



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