

## Consulting Report

### 2315 IRS Form W-4P Process Review

May 22, 2023

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The LASERS Audit Committee

#### BACKGROUND

This was a planned engagement on the fiscal year end (FYE) 2023 Audit Plan. The fieldwork for this engagement was completed on May 3, 2023.

The Internal Revenue Service (IRS) redesigned Form W-4P, Withholding Certificate for Periodic Pension or Annuity Payments, for 2022. The new Form W-4P is now used only to make federal income tax withholding elections for periodic pension or annuity payments. Withholding elections for nonperiodic payments and eligible rollover distributions can be made using Form W-4R, Withholding Certificate for Nonperiodic Payments and Eligible Rollover Distributions. These forms were available for use in 2022; however, the IRS postponed the requirement to begin using the new Form W-4P and W-4R until January 1, 2023. LASERS began requiring payees to use the new Form W-4P in March 2022.

LASERS was required to make updates to the W-4P process based on changes described above. Initially, LASERS decided to implement the new W-4P process in 2022, prior to the required date of January 1, 2023. The optimal solution would have been for the applicable modules in the SOLARIS production environment to be updated so that W-4P forms could be processed. However, due to timely updates not being able to be completed in the SOLARIS production environment, a temporary process was required to be developed outside of the system (hereafter referred to as “work around”) by Fiscal and IT. The W-4P related updates are scheduled to be implemented in SOLARIS production when the Pension Payroll project is complete. The work around process is not performed for W-4P forms where the payee elects to have no federal taxes withheld or a fixed amount of taxes withheld, as these elections are changed directly in the SOLARIS production environment by Fiscal.

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## EXECUTIVE SUMMARY

This project included a review of LASERS current W-4P process for withholding federal income taxes from benefit payments. One observation was noted which relates to possible improvements for the W-4P work around process.

## SCOPE, OBJECTIVES, AND METHODOLOGY

The scope of this engagement included a review of changes made to the W-4P process based on the new federal income tax withholding calculation method required by the IRS.

The objectives of this engagement were to determine if the temporary W-4P process ensures:

- Compliance with the new calculation method required by the IRS.
- Federal income tax is properly withheld from benefit payments.

Procedures used to complete this engagement included:

- Performing automated testing of payments covered by the Form W-4P using Audit Command Language (ACL).
- Performing sample based manual testing of W-4P forms received and W-4P records processed between January 1, 2022 and November 9, 2022.
- Reviewing the temporary W-4P process established by Fiscal and IT.
- 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 and the policies and procedures of the Audit Services Division.

## OBSERVATION, RECOMMENDATIONS, AND RESPONSES

### 1. POSSIBLE IMPROVEMENTS RELATED TO THE W-4P WORK AROUND PROCESS

Fiscal staff is generally only required to update federal income tax withholding information for payees when a new W-4P form is received by LASERS. However, the current work around process requires Fiscal to independently calculate and update a federal tax withholding in the following additional instances which results in an increased workload on Fiscal staff:

- When a benefit is finalized with a one-time retro component.
- After a one-time retro component has been paid.
- Anytime a benefit amount changes outside of the benefit finalization process.

Updates to federal tax withholding resulting from new W-4P forms submitted in 2022 began taking effect with the April 1, 2022 payroll. A SOLARIS non-production environment was updated with functionality to capture the information from new W-4P forms received and derive the new federal tax withholding amount accordingly. IT created fixed tax withholding records in the SOLARIS production environment, via a batch process, based on the information in this non-production environment. Additionally, since the beginning of the work around process, Fiscal has maintained all federal tax withholding updates for payee records in a spreadsheet to keep track of information related to the calculation. The spreadsheet is used to ensure that federal tax withholding updates made in the SOLARIS production environment are correct and to keep track of payees that may possibly need to have their federal withholding tax amount updated in the future.

In February 2023, a change was made to the work around process due to errors discovered in W-4P tax withholding calculations performed in the SOLARIS non-production environment where the payment includes one-time components. The process change now requires IT to use Fiscal's tracking spreadsheet to make updates to tax withholding records in the SOLARIS production environment. This change has increased the risk of error since manually maintained data is being used to update the federal withholding amount in the SOLARIS production environment for W-4P forms processed by Fiscal. It should be noted that Fiscal continues to enter information from W-4P forms into the non-production SOLARIS environment in order to ensure the data is stored electronically.

Starting in November 2022, Audit Services began performing independent testing to evaluate whether federal tax withholding amounts were being correctly calculated and in compliance with the new method required by the IRS. One-time testing included random sample selections of records to manually review and confirm new W-4P forms were properly processed. Ongoing automated testing is also being performed to independently calculate federal tax withholding amounts and compare with the actual amount withheld according to the SOLARIS Payment History data for payments covered by the W-4P form. The table below summarizes the approximate number of W-4P transactions processed by Fiscal via the work around process during each testing period and the number of exceptions identified during testing that required updates to correct federal tax withholding errors on payee records. The monetary impact of the exceptions varied due to each payee's individual tax situation. Since the IRS does not appear to specify a tolerance for tax withholding errors, all exceptions were submitted to Fiscal for review and correction.

Monthly Payroll Testing Period	New W-4P Forms Processed	Benefit Changes Processed	Total Transactions Processed	# of Exceptions	Exception Rate
January 2023*	N/A*	N/A*	N/A*	37	N/A*
February 2023	329	95	424	4	.9%
March 2023	279	130	409	4	.9%
April 2023	331	191	522	8	1.5%
May 2023	313	211	524	6	1.1%
*Initial testing in January 2023 included historical records starting with the April 2022 monthly payroll. Processing information not applicable since a snapshot of the data at the time it was processed with each historical payroll was not readily available.					

Based on these independent testing results, the work around process appears to be generally effective in ensuring federal tax withholding amounts for new W-4P forms processed are correct. However, over a 4-month period, the work around process required Fiscal staff to review approximately 620 more records for possible updates to tax withholding amounts. This review process was not required prior to the work around and will not be required after SOLARIS is updated with the new tax functionality. Additionally, the longer the work around process is in place, there is an increased likelihood that the total transactions processed will continue to grow as the population of payees with a new W-4P form increases. This will require additional time and effort to manage the work around process. Currently, there is not an agreed upon projected date as to when the work around process will no longer be necessary.

The following are example recommendations that would result in overall improvements to the current work around process and would more closely align the work around process with the functionality being planned for the SOLARIS production environment:

- Correcting the existing issues with the W-4P calculation process in the SOLARIS non-production environment.
- Create or update the appropriate tax entry in SOLARIS production immediately after a W-4P calculation is processed in the SOLARIS non-production environment. This could be accomplished via similar logic

used in the batch process that creates/updates tax entries in the SOLARIS production environment prior to each monthly benefit payroll.

- Developing an automated process to identify and update tax withholding for payees whose benefit amount has changed as compared with the prior payroll and calculating their federal tax withholding based on the new W-4P process. This should eliminate the need for Fiscal to track and maintain information in a spreadsheet and Optimus.

### **RECOMMENDATION #1**

Generally, a recommendation based on the details of this observation would entail evaluating the work around process to identify areas for improvement and implementing changes accordingly. However, during this review, management expressed their decision to keep the work around process “as is” to ensure related IT resources remain devoted to the SOLARIS Pension Payroll project. Therefore, it is recommended that Fiscal work with IT and Executive to formally document the acceptance of the risks associated with the work around process.

### **RESPONSE**

Executive, Fiscal, and IT accept the risks and inefficiencies of the Form W-4P work around process because the SOLARIS Pension Payroll project is expected to be completed in less than a year. We are actively monitoring the progress of the Pension Payroll project and will revisit our acceptance of risk if the work around becomes a longer term solution.

### **RECOMMENDATION #2**

Due to the manual nature of the current work around process, Fiscal should implement a process to independently verify the accuracy of federal tax withholding prior to each payroll run for all payment types covered by the W-4P form.

### **RESPONSE**

Fiscal agrees with the recommendation and will work with Audit on assuming the responsibility for running and maintaining the ACL script developed by Audit which verifies the accuracy of Federal tax withholding prior to each payroll for all payment types covered by the Form W-4P. The priority for this item has been set as medium with a target completion date of July 31, 2023.

## **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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