September 28, 2005

VINCENT H. DEVITO, JR.
MANAGER, CORPORATE ACCOUNTING

SUBJECT: Management Advisory – Reporting Salary Overpayments to the Internal Revenue Service (Report Number FT-MA-05-002)

This report presents an issue regarding the Postal Service's compliance with Internal Revenue Service (IRS) employment tax regulations related to salary overpayments. We identified this issue during our annual audit of the fiscal year 2005 Postal Service Financial Statements at the Eagan Information Technology and Accounting Service Center (IT/ASC) (Project Number 05BM001FT001). Specifically, the Postal Service did not report $5.5 million of salary overpayments on Forms W-2, Wage and Tax Statements it issued to current and former employees. Additionally, the Postal Service inappropriately corrected $2.3 million in prior years' social security wages. As a result, the Postal Service incorrectly reported employee income and taxes to the IRS on its Form 941, Employer's Quarterly Federal Tax Return.

Background

IRS employment tax regulations require every employer to deduct and withhold appropriate taxes from the payment of wages. In addition, employers are required to include overpayments in employees' income for the calendar year they make the overpayments if employees do not repay them by the end of that calendar year. Further, the overpayment amounts are subject to withholding for federal, social security, and Medicare taxes.

Postal Service policy states overpayments may result from errors in payroll salaries, errors in deductions, workers' compensation cases, and overdrawn leave.[1] In calendar year (CY) 2004, approximately 52 percent of salary overpayments resulted from overdrawn annual and/or sick leave. In cases of overpayments, Postal Service policy is to collect the amount of the overpayment from the employee by establishing an accounts receivable.

[1] In general, the Postal Service advances annual leave during the first full pay period of each calendar year. This advance leave balance reduces as the employee earns annual leave hours each pay period. Overdrawn leave results when an employee terminates with a balance of leave used but not earned.

The Postal Service establishes accounts receivable for errors in payroll salaries and errors in deductions at the time of discovery, but does not establish accounts receivable for overdrawn leave until an employee separates from duty. In cases of death or retirement due to disability, the Postal Service does not take action to collect overpayments related to overdrawn leave.

Objective, Scope, and Methodology

The objective of this part of the audit was to determine whether the Postal Service complied with IRS employment tax regulations regarding salary overpayments. We conducted this work at the Eagan IT/ASC. The Eagan IT/ASC is one of three Postal Service-wide accounting service centers.[2] The Eagan center is responsible for processing payroll and related functions for the entire Postal Service.

To accomplish our objective, we extracted employee accounts receivable the Postal Service established specifically for salary overpayments[3] in CY 2004[4] that were outstanding at the end of the calendar year. During our audit, we reviewed pertinent Postal Service policies and procedures and IRS employment tax regulations to determine proper reporting methods for overpayments. In addition, we reviewed W-2 and payroll history files to determine actual Postal Service procedures for establishing accounts receivable for salary overpayments. Further, we interviewed IRS representatives and Postal Service management from the Eagan IT/ASC and Postal Service Headquarters.

This report excludes Economic Value Added overpayments that occurred in pay period 13, 2004.[5] On June 18, 2004, we issued a report on the processing error that occurred related to these overpayments.

We conducted this part of the audit from February through September 2005, in accordance with generally accepted government auditing standards. We relied on data from the Postal Service's Oracle Applications accounts receivable system. We did not test internal controls during this review. Internal controls will be tested separately as part of our annual financial statement audit work. We discussed our observations and conclusions with management officials and included their comments where appropriate.

Prior Audit Coverage

We did not identify any prior audits or reviews related to the objective of this review.

[2]The other IT/ASCs are located in San Mateo, California, and St. Louis, Missouri.
[3]Overpayments relate to overdrawn annual and sick leave and payroll salary errors.
[4]Transactions occurring from the beginning of pay period 1 (December 13, 2003) through the end of pay period 27 (December 24, 2004).
[5]Postal Service Calendar Year 2004 Pay Schedule; May 29 through June 11, 2004.

Results

Reporting Salary Overpayments to the IRS

The Postal Service did not always follow IRS employment tax regulations for reporting salary overpayments when employees did not repay the entire amount by the end of the calendar year in which the Postal Service made the payment. This occurred because Postal Service policy is not consistent with IRS regulations governing salary overpayments.

When salary overpayments occur in the current year and reimbursement is required, Postal Service policy[6] requires reversal of the gross overpayment amount[7] and applicable taxes from the employee's year-to-date payroll amounts. This reversal entry excludes the overpayment and applicable taxes from the employee's Form W-2.[8] The IRS accepts this method for amounts employees repay within the same calendar year. The Postal Service also establishes an employee account receivable for the "net" overpayment amount.[9] Additionally, when the Postal Service establishes an account receivable for a prior year salary overpayment, it issues a corrected Form W-2 to reverse the social security wages and taxes even in cases where the repayment does not occur.

In Revenue Ruling 70-177, the IRS held that "for purposes of Section 3402(a) of the Code (federal income tax withholding) the amount of an erroneous salary payment received by a federal employee was wages subject to income tax withholding and, therefore, to the extent there has been no repayment of such amount by the employee within that same year, the Form W-2 must reflect the full amount received by the employee in that year." Additionally, Title 26, Internal Revenue Code, Section 3402(a) (1954) states, in part, "every employer making payment of wages shall deduct and withhold upon such wages a tax. . . .".

In a letter from the IRS dated August 3, 2005, the chief, Employment Tax Branch 2, Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), advised the Office of Inspector General (OIG) that the code applies to outstanding balances even when an employee makes a partial payment. Therefore, when an employee does not make full repayment within the same calendar year, the Postal Service must include the outstanding amount of the overpayment and applicable taxes on the employee's Form W-2. If the Postal Service does not include these overpayments and applicable taxes on the Form W-2, the employee may be underreporting income and appropriate taxes to the IRS for that calendar year. Also, for

[6]Handbook F-24, Payroll Processing Manual, Section 456.62, effective May 31, 1987.
[7]Gross overpayment amount is the total overpayment prior to any deductions.
[8]Reversal does not apply to current year gross earnings when an accounts receivable is established for a prior year salary overpayment; however, social security taxes and wages and Medicare taxes are reversed and corrected Forms W-2 are issued.
[9]Net overpayment amount is the total amount paid less all deductions.

prior year overpayments, the Postal Service should not issue a corrected Form W-2 to the employee to adjust social security wages and taxes and Medicare taxes until the employee makes a full repayment.

As of the end of Postal Service calendar year 2004, approximately $5.5 million in salary overpayments established during that calendar year remained outstanding. Also, the Postal Service incorrectly adjusted $2.3 million in social security wages related to prior year salary overpayments. As a result, the Postal Service incorrectly reported employee income and taxes to the IRS on its Form 941 for that period.

Several revenue rulings issued in prior years support the IRS's position, including rulings to other federal agencies.

If the Postal Service does not comply with IRS employment tax regulations, it could be subject to fines and penalties. Compliance with IRS regulations may provide an incentive to employees to repay their debts to the Postal Service, thereby reducing the Postal Service's bad debts expense.

Recommendations

We recommend the manager, Corporate Accounting:

1. Revise Postal Service policy to reduce federal tax liability and provide credit to employees only when they make repayment in the same calendar year, to comply with Internal Revenue Service employment tax regulations.

2. Revise Postal Service policy to reduce social security and Medicare tax liability and issue corrected Forms W-2 only when employees make repayment within the statute of limitations, to comply with Internal Revenue Service employment tax regulations.

3. Revise Postal Service policy to establish accounts receivable for gross amount due, including all taxes.

4. Inform employees of the tax implications of not repaying an overpayment by the end of a calendar year.

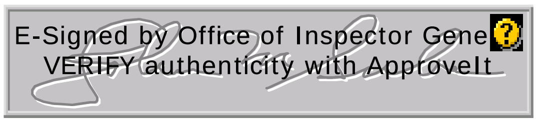
Management's Comments

Management agreed with the recommendations, but advised compliance requires extensive system changes and process changes. The target date for completion is June 30, 2006, to allow for both accounts receivable and payroll system personnel to develop requirements, complete programming, and perform acceptance testing. Management plans to convey tax implications to employees on the employee receivable, if feasible, or in letters of demand. Management's comments, in their entirety, are included in the appendix of this report.

Evaluation of Management's Comments

Management's comments are responsive to the recommendations, and actions planned should correct the issues identified in the finding.

We appreciate the cooperation and courtesies provided by your staff. If you have any questions or need additional information, please contact Lorie Siewert, Director, Financial Statements, or me at (703) 248-2300.



John M. Seeba
Deputy Assistant Inspector General
for Financial Operations

Attachment

cc: Lynn Malcolm
Jon T. Stratton
Kevin T. McNamara
Jo Ann Mitchell
Elizabeth Novillis
Steven R. Phelps

APPENDIX A. MANAGEMENT'S COMMENTS

MANAGER
ACCOUNTING

UNITED STATES
POSTAL SERVICE

September 23, 2005

KIM H. STROUD
DIRECTOR, AUDIT REPORTING

SUBJECT: Draft Management Advisory – Reporting Salary Overpayments to the Internal Revenue Service (Report Number FT-MA-05-DRAFT)

This is in response to the findings and recommendations in the above named management advisory.

Recommendation #1

Revise Postal Service policy to reduce federal tax liability and provide credit to employees only when they make repayment in the same calendar year, to comply with Internal Revenue Service employment tax regulations.

Response

We agree with this recommendation, however, this will require extensive system changes as well as process changes. With the complexity of the payroll system and the large volume of transactions, we can not afford a manual solution; it must be done programmatically. We will have to modify the payroll calculation routines to bypass any receivable that would reduce the W-2 gross income for the current year. To reduce W-2 earnings for the current year based on repayments, we would have to program an interface to accept data from the accounts receivable system. In addition, we would have to program for changes to social security and Medicare tax liability for prior years within the statue of limitations and issue a W-2C.

The accounts receivable system will also require modification. The system will have to track receivables and payments by W-2 year. An extract file will be required to send payroll the payment information to update the current year W-2 and the social security and Medicare tax liability for the prior non barred years.

The process changes would be: (1) establish the receivable for gross not net; and (2) identify and separate adjustments and/or receivables by year that cross W-2 years.

Since we cannot change the processes without the system changes, the target date is on or before June 30, 2006. The date is driven by the complexity of the modifications and the mandatory changes (i.e. child support proration, contract increases, TSP cap, open seasons, W-2 processing, etc.) currently scheduled for the payroll system. Both the accounts receivable and payroll systems need to develop the requirements, complete the necessary programming, and perform system and customer acceptance testing.

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Recommendation #2

Revise Postal Service policy to reduce social security and medicare tax liability and issue corrected Forms W-2 only when employees make repayment within the statue of limitations, to comply with Internal Revenue Service employment tax regulations.

Response

We agree with this recommendation and will implement this practice in the same time frame as the system changes, on or before June 30, 2006.

Recommendation #3

Revise Postal Service policy to establish accounts receivable for gross amount due, including all taxes.

Response

We agree with this recommendation and will implement this practice in the same time frame as the system changes, on or before June 30, 2006.

Recommendation #4

Inform employees of the tax implications of not repaying an overpayment by the end of the calendar year.

Response

We agree with this recommendation and will implement this practice in the same time frame as the system changes, on or before June 30, 2006. The information will be on the employee receivable; however, if that is not programmatically possible, it will be included in the letter of demand.

Vincent H. DeVito, Jr.

cc: Lynn Malcolm
Kevin McNamara
Jo Ann Mitchell
Elizabeth Novillis
Steven Phelps
Jon Stratton