Subject: Collection of Wage Overpayments	Author: Kerry Schmidt
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It is the policy of University of Louisville Payroll Services to initiate collection proceedings on all payroll overpayments as soon as the discrepancy is detected.

The individual, as well as the respective department, should be advised that the University of Louisville in its capacity as a state agency is subject to all applicable state laws and regulations. The Kentucky Revised Statutes presently prohibit any further or future compensation to employees who are indebted to the state until the indebtedness to the Commonwealth of Kentucky is satisfied.

It is the intention of Payroll Services to work amicably with the affected employee, while acting responsibly in administering state regulations, to effect an orderly return of all excess payments to the University without causing undue financial hardship to the individual. However, in instances when the employee is unwilling to establish terms of repayment suitable to the University, Payroll Services will exercise its responsibility and authority not to pay the affected employee until such time as the overpayment obligation is totally satisfied.

Suitable terms governing the orderly repayment of an overpayment may be interpreted as an amount of time equal to the time over which the overpayment was incurred. For example, an employee who was overpaid over a three-month period will be afforded an opportunity to repay the overpayment over a three-month period. Requests for extension of the repayment period should be directed to the Director of Disbursement Services, whose decision may be appealed to the Assoc. Vice President for Finance/Controller.

The amount of overpayment collected by Payroll Services will vary depending upon whether the current and/or prior calendar year records must be adjusted. If only the current calendar year is involved, the employee would be responsible for returning to the University the net amount of the overpayment. The overpaid social security, federal, state, and municipal taxes will be adjusted through the payroll system in the next payroll cycle.

If a prior calendar year is involved, and the University has previously filed final tax returns for that year, the employee would be responsible for returning to the University the net amount of the overpayment plus all overpaid taxes credited in error to the employee gross. Payroll Services will issue an amended W-2 for the year affected.

If a prior calendar year is involved, and the University has not filed final tax returns for the previous year, the employee would be responsible for returning only the net amount of the overpayment to the University. The overpaid taxes will be adjusted by Payroll Services prior to submission of the University's tax returns. Overpayments of this nature detected following the close of a calendar year may require the reissuance of the employee's annual wage and tax statement (W-2).

Procedure

Wage repayments are handled differently depending upon when the overpayment is actually recovered.

The Internal Revenue Service requires employers to provide background information and certifications supporting prior quarter adjustments. For prior quarter adjustments, a statement is required which details:

- What the error was
- Period in which the error was made
- The amount of the error for each period
- Date on which the error was discovered

If the entry corrects social security and Medicare taxes overcollected in an earlier year, an attestation the University has received from the employee that the employee will not claim a refund or credit for the amount.

The University cannot adjust amounts reported as income tax withheld in a prior calendar year unless it is to correct an administrative error. An administrative error occurs if the amount reported on the University’s tax return is not the amount actually withheld. For example, the total income tax withheld was incorrectly reported on the University’s tax return due to a mathematical or transposition error, this would be an administrative error. An administrative error adjustment corrects the amount reported on the quarterly tax return to agree with the amount actually withheld from employees.

Repayment of Current Year Wages

If the University receives repayment(s) for wages paid during a prior quarter of the current calendar year, Payroll Services is allowed to recover income tax withholding and social security and Medicare taxes for the repaid wages. Consequently, the affected employee repays only the respective net pay, because the associated withholding taxes are recoverable by Payroll Services.

Repayment of Prior Year Wages

If the University receives repayment(s) for wages paid during a prior calendar year, Payroll Services is allowed to recover only the applicable social security and Medicare taxes. Consequently, the affected employee must repay the respective gross pay, because the associated withholding taxes are non-recoverable Payroll Services. (Taxes are permanently credited to the employee on December 31 and cannot be subsequently recalled.)

Payroll Services is required to file IRS Form W-2C, Corrected Wages and Tax Statement, to correct social security and Medicare wages and taxes. The University is not permitted to correct federal taxable wages.

The wages paid in error in the prior year remain taxable to the employee for that year. This is because the employee received and had use of those funds during that year. The employee is not entitled to file an amended return (IRS Form 1040X) to recover the income tax on these wages. Instead, the employee is entitled to a deduction (or credit in some cases) for the repaid wages on his or her income tax return for the year of repayment.

If an employee repays an amount that was included in his/her income in an earlier tax year, he/she may be able to deduct the amount repaid from his/her income for the year in which the employee repays the overpaid wages.

If the amount repaid is more than $3,000, the employee may be able to take a credit against his/her tax for the year in which repayment is made. An overpayment of prior year wages must be handled as a miscellaneous itemized deduction on Schedule A (Form 1040).

Repayment of $3,000 or Less

If the amount the employee repaid was $3,000 or less, the employee must deduct the repayment as a miscellaneous itemized deduction on Schedule A (Form 1040).

Repayment Over $3,000

If the amount the employee repaid was more than $3,000, the employee can deduct the repayment; however, the employee can choose instead to take a tax credit for the year of repayment if the employee included the income under a claim of right. This means that at the time the employee included the income, it appeared that the employee had an unrestricted right to it. If the employee qualifies for this choice, the employee figures his/her tax under both methods and compares the results. The employee uses the method (deduction or credit) that results in less tax.

Method 1

Figure the tax for the current tax year, claiming a deduction for the repaid amount. Repaid wages must be deducted as a miscellaneous itemized deduction.

Method 2

Figure the tax for the current year claiming a credit for the repaid amount following these steps.

1. Figure the tax for the current year without deducting the repaid amount.
2. Refigure the tax from the earlier year without including in income the amount repaid during the current year.
3. Subtract the tax in (2) from the tax shown on the return for the earlier year. This is the credit.
4. Subtract the answer in (3) from the tax for the current year figured without the deduction (step 2).

If method 1 results in less tax, deduct the amount repaid. If method 2 results in less tax, claim the credit figured in (3) above on Form 1040, line 70, and enter “I.R.C. 1341” in the column to the right of line 70. An example of the deduction/credit calculations are contained in IRS Publication 525 under the heading of Repayments.

References:

IRS Publication 15, (Circular E), Employer's Tax Guide (pdf)

IRS Publication 525, Taxable and Nontaxable Income (pdf)