Office of Inspector General

March 2005
Report No. 05-014

The FDIC's Process for Writing Off Assets

AUDIT REPORT

Office of Audits

oig

Report No. 05-014
March 2005

Office of Audits

OIG

Background and Purpose of Audit

The FDIC's Division of Resolutions and Receiverships (DRR) is responsible for resolving failed FDIC-insured depository institutions promptly, efficiently, and responsively in order to maintain public confidence in the nation's financial system. Once the resolution has occurred, the FDIC is appointed as receiver to wind up the closed institution's affairs including its liquidation and the disposition of assets. Until assets are sold (dispositioned), DRR performs required asset servicing in order to maintain the assets' values. When reasonable attempts to sell or recover assets have been unsuccessful and additional expenditure of FDIC resources is unjustified, the FDIC may write off the assets.

In processing write-off transactions, the FDIC is required to report a canceled debt of $600 or more on Form 1099-C, *Cancellation of Debt*, to the Internal Revenue Service (IRS).

Our audit scope included 435 write-off cases, valued at $292 million. We reviewed a sample of 24 write-off cases valued at about $95 million.

The audit objective was to determine whether DRR's decisions for writing off assets from failed financial insured depository institutions were properly justified and adequately supported.

To view the full report, go to www.fdicig.gov/2005reports.asp

The FDIC's Process for Writing Off Assets

Results of Audit

The FDIC has established a sound internal control process and procedures for writing off receivership assets in conformity with DRR delegations of authority. For the 24 write-off cases we sampled, the decisions to write off receivership assets from failed depository institutions were justified and adequately supported.

We also found, however, eight write-off cases totaling $31 million in debt for which DRR had not issued Forms 1099-C in compliance with FDIC and IRS policies and directives. As a result, the government may have been deprived of significant tax revenue.

Recommendations and Management Response

We recommended that DRR improve procedures related to reporting discharges of debt, issue Forms 1099-C for the write-off cases identified in the report, and review all write-off cases for 2003 and 2004 to ascertain whether reporting of additional discharges of debt is warranted. DRR concurred with two of our recommendations and partially concurred with the third recommendation. Regarding the partial concurrence, DRR agreed to issue Forms 1099-C for the seven write-off cases that involved loans to foreign debtors and loans discharged in corporate bankruptcies. DRR did not agree to issue the forms for the remaining case because the taxable event occurred before bank failure, and DRR stated that it is not its policy to issue a Form 1099-C in this circumstance. Notwithstanding, DRR has requested an FDIC Legal Division opinion regarding the appropriateness of that policy. We consider management's planned actions responsive to the recommendations.

Asset Write-Offs Requiring the Issuance of Form 1099-C

Nature of Write-Off	Number of Cases	Value of Cases
Loans to Foreign Debtors	4	$16,894,282
Loans Discharged in Corporate Bankruptcies	3	13,346,240
Loans Previously Written Off by a Failed Institution	1	418,026
Totals	**8**	**$30,658,548**

Source: OIG review of DRR asset case files.

Federal Deposit Insurance Corporation
801 17th Street NW, Washington, DC 20434

Office of Audits
Office of Inspector General

DATE: March 31, 2005

MEMORANDUM TO: Mitchell L. Glassman, Director
Division of Resolutions and Receiverships

FROM: Russell A. Rau [Electronically produced version; original signed by Russell A. Rau]
Assistant Inspector General for Audits

SUBJECT: *The FDIC's Process for Writing Off Assets*
(Report No. 05-014)

This report represents the results of the Federal Deposit Insurance Corporation (FDIC) Office of Inspector General's (OIG) audit of the FDIC's process for writing off assets from failed insured financial depository institutions. A full or partial write-off of a receivership[1] asset occurs when the amount of the asset is removed from the books of record because the value of the legal obligation of the debtor has been declared a loss. The write-off process is described in detail in the Background section of this report.

The objective of the audit was to determine whether decisions to write off assets from failed insured depository institutions were properly justified and adequately supported. The scope of our audit included B-25 delegation of authority[2] write-off cases from January 1, 2003 through September 30, 2004. According to the Division of Resolutions and Receiverships (DRR), 435 B-25 write-off cases had a book value of about $292 million for the period covered in our audit. Additional details on our objective, scope, and methodology are presented in Appendix I.

BACKGROUND

The FDIC is charged with the resolution of failing FDIC-insured financial institutions. Once the resolution has occurred and the FDIC is appointed receiver for the closed institution, DRR inventories and values any remaining assets and uses various strategies to sell or recover assets. The disposition of certain assets can be lengthy. In the interim, DRR performs required asset servicing (building maintenance, processing of loan payments, etc.) in order to maintain the assets' values until they are sold.

[1] Receiverships are failed financial institutions for which the FDIC has been appointed as receiver to manage the liquidation (asset sales, loan servicing, claims resolution, etc.) of the institution's remaining assets.
[2] The delegation of authority to the Director, Division of Resolutions and Receiverships, is limited to assets with a book value of $25 million or less. B-25 is the delegated authority provision for write-offs—either non-discretionary (B-25a) or discretionary (B-25b).

DRR Account Officers are responsible for managing the disposition of the assets. When reasonable attempts to sell or recover assets have been unsuccessful and the DRR Account Officer believes that additional expenditure of FDIC resources are unjustified, the Account Officer may request that the assets be written off. According to the FDIC, the full or partial write off of an asset occurs when the FDIC removes the amount of the asset from the books of record because the value of the legal obligation of the debtor has been declared a loss.

According to DRR's *Asset Disposition Manual*, the Account Officer begins the write-off process with the preparation of a case memorandum. The case memorandum should be a persuasive written document used to request and obtain authority to act with respect to an asset. The delegations of authority determine the level for which a case is written. The cases have a two-fold purpose: (1) to seek authority from the proper individual or committee and (2) to create a permanent record, in the form of an asset file, of the FDIC's actions taken to conform to its fiduciary responsibilities. The asset file must contain adequate documentation to demonstrate that a reasonable attempt to recover the asset has been made. Once the write-off request is processed, the write-off information is maintained in the FDIC's National Processing System (NPS), which DRR uses to account for loans and related financial transactions required from failed depository institutions.

Internal Revenue Service (IRS) regulations regarding reporting discharges of indebtedness are contained in 26 U.S.C. 6050P, *Information Reporting for Discharges of Indebtedness by Certain Federal Agencies*. FDIC guidance regarding reporting discharges of indebtedness is primarily contained in two documents. FDIC Circular 5400.1, *Reporting for Discharge of Indebtedness (IRS Forms 1099)*, dated May 1, 2001, contains guidance for the Account Officers on the events requiring the reporting of the discharges of indebtedness. The circular states that a Form 1099-C must be filed with the IRS for each debtor for whom a debt of $600 or more is canceled. DRR's Field Financial Office (FFO) *Accounting Manual* provides instructions for handling write-off transactions. The FDIC's failure to issue a Form 1099-C, when appropriate to do so, subjects the FDIC to potential IRS penalties and theoretically deprives the government of potential tax revenue.

RESULTS OF AUDIT

The FDIC has established a sound internal control process and procedures for writing off receivership assets managed by DRR Account Officers in conformity with DRR delegations of authority. For the 24 write-off cases we sampled, the decisions to write off receivership assets from failed depository institutions were properly justified and adequately supported. Accordingly, DRR has reasonable assurance that established processes and procedures were implemented as designed. However, we identified eight write-off cases involving about $31 million in debt for which DRR had not issued Forms 1099-C in compliance with FDIC and

IRS policies and directives. As a result, the government may have been deprived of significant tax revenue.[3]

IRS Requirements for Filing Form 1099-C

The FDIC must file Form 1099-C for each debtor for whom the FDIC has canceled a debt of $600 or more when an identifiable event has occurred. IRS regulations define an identifiable event as:

- a discharge of indebtedness under Title 11 of the U.S. Code (bankruptcy);
- a cancellation or extinguishment of indebtedness that renders a debt unenforceable in a receivership, foreclosure, or similar proceeding in federal or state court;
- a cancellation or extinguishment of indebtedness upon the expiration of a statute of limitations for collection of an indebtedness;
- a cancellation of indebtedness pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor's right to pursue collection;
- a cancellation of indebtedness that renders a debt unenforceable pursuant to a probate or similar proceeding;
- a discharge of indebtedness pursuant to an agreement between an applicable entity and a debtor to discharge indebtedness at less than full consideration; or
- the expiration of the non-payment testing period as described in the regulation.

Receivership Assets Written Off but Not Reported by DRR

The write-off cases for which DRR did not issue the required Forms 1099-C for discharges of debt fell into several categories as shown in the table below. Generally, the forms were not issued because the Account Officers involved were not fully aware of the reporting requirements associated with these rather atypical write-offs. A summary of the circumstances surrounding each category of write-off follows. Additional details regarding the specific write-off cases were provided separately to DRR for its use in resolving our finding.

Asset Write-Offs Requiring the Issuance of Forms 1099-C

Nature of Write-Off	Number of Cases	Value of Cases
Loans to Foreign Debtors	4	$16,894,282
Loans Discharged in Corporate Bankruptcies	3	13,346,240
Loans Previously Written Off by a Failed Institution	1	418,026
Totals	**8**	**$30,658,548**

Source: OIG review of DRR asset case files.

[3] A Department of Defense, Office of Inspector General, report entitled, *Department of Defense Compliance with Federal Tax Reporting Requirements* (Report No. 95-234), dated June 14, 1995, states that when IRS Forms 1099 are not filed, recipients report only about 28.8 percent of the income on their tax returns. Therefore, based on our sample alone, as much as $22 million of the $31 million may not have been reported by debtors on their tax returns.

Loans to Foreign Debtors: DRR did not file Forms 1099-C for four write-off cases totaling $16,894,282 in loans to foreign debtors. For example, DRR wrote off an $8.7 million loan to a foreign debtor but did not issue the appropriate Form 1099-C. The DRR Account Officer responsible for this asset stated that he was unaware of the requirement to issue Form 1099-C to a debtor with a foreign address. However, DRR's failure to issue the form is contrary to IRS regulations. Further, FDIC Circular 5400.1 states, "It is not the responsibility of the FDIC to determine what is taxable income, only to report the discharge, regardless of circumstances."

In addition, DRR's *Accounting Manual* provides an example of when reporting discharges of debt to the IRS is not required, which is misleading and incorrect. Specifically, the example describes a foreign customer with a foreign address which is not in conformity with the IRS regulations. The regulations state that if a foreign entity has income from any U.S. source, the entity must file a U.S. tax return. Therefore, DRR should have filed Forms 1099-C for the four cases.

Loans Discharged in Corporate Bankruptcies: DRR did not file Forms 1099-C for three write-off cases totaling $13,346,240 in loans discharged as part of corporate bankruptcies. For example, a corporation was granted bankruptcy protection, which included a debt of about $4.8 million owed to an FDIC receivership. The DRR Account Officer determined that repayment was unlikely and recommended writing off the debt. However, according to FDIC Circular 5400.1, a corporate bankruptcy is an event requiring issuance of Form 1099-C.

For two other bankruptcy cases totaling $8.5 million, a DRR official agreed that Forms 1099-C should have been issued and intends to issue them after collection activity on related loans has concluded.

Loans Previously Written Off by a Failed Institution: DRR did not file Forms 1099-C for over 100 loans valued at $418,026 that had been charged off by a bank prior to failure but had not been reported to the IRS. When the FDIC took control of the bank, the FDIC recorded the loans in the receivership records as a "control total"[4] for accountability purposes. The DRR Account Officer recommended that the control total be written off the receivership records. However, when doing so, DRR did not issue Forms 1099-C for the individual discharged debts. According to DRR, the forms were not issued because the loan files were in poor shape, and DRR did not want to risk issuing incorrect forms. However, because the legitimacy of the discharged amount of debt is a matter to be resolved between the debtor and the IRS, this is not a valid reason for failing to report the discharges of debt.

CONCLUSION AND RECOMMENDATIONS

The decisions to write off receivership assets that we reviewed were properly justified and adequately supported. However, the Corporation should take steps to ensure that the government is not deprived of significant tax revenue resulting from cases we identified and that similar cases are properly reported in the future.

---

[4] A "control total" represents the total book value attributed to one or more individual assets that have been aggregated for reporting purposes.

We recommend that the Director, DRR:

(1) Revise FDIC Circular 5400.1, *Reporting for Discharge of Indebtedness (IRS Forms 1099)*, and the supporting manuals to better conform with IRS regulations requiring the issuance of Forms 1099-C.

(2) Issue Forms 1099-C for those write-off cases identified in the report and provided to DRR that had not been reported to the IRS.

(3) Review all write-offs for 2003 and 2004, and issue Forms 1099-C, if appropriate.

CORPORATION COMMENTS AND OIG EVALUATION

On March 10, 2005, the Director, DRR, provided a written response to a draft of this report. The response is presented in its entirety in Appendix II of this report. The Director concurred with recommendations 1 and 3 and partially concurred with recommendation 2. A summary of the Director's responses and our analysis follows. See Appendix III for additional details on the status of the recommendations.

The Corporation's planned actions addressed recommendations 1 and 3. Regarding the 11 write-off cases discussed in a draft of this report and in management's comments related to recommendation 2, DRR agreed to issue Forms 1099-C for the seven cases, totaling $30,240,522, that involved loans to foreign debtors ($16,894,282) and loans discharged in corporate bankruptcies ($13,346,240). For the three cases (totaling $20,967,928) that were discussed in the draft of this report and related to various non-loan assets, DRR provided additional information supporting its position that Forms 1099-C were not necessary under the circumstances. We revised the report accordingly. Finally, DRR did not agree to issue Forms 1099-C for the remaining case totaling $418,026. Specifically, the taxable event for that case occurred before bank failure, and DRR indicated that its policy is not to issue a Form 1099-C in that circumstance. Nevertheless, DRR has requested an opinion from the FDIC's Legal Division regarding the appropriateness of that policy.

Taking into consideration that Forms 1099-C are not necessary for the three non-loan asset write-offs, we maintain that the forms should be issued for the eight write-off cases totaling $30,658,548. We consider management's planned actions responsive to the recommendations, which are resolved but will remain undispositioned and open until we have determined that agreed-to corrective actions have been completed and are effective.

OBJECTIVE, SCOPE, AND METHODOLOGY

The audit objective was to determine whether DRR's decisions for writing off assets from failed financial insured depository institutions were properly justified and adequately supported. The audit focused on determining compliance with, and the adequacy of, existing policies and procedures and identifying opportunities for minimizing losses to the insurance funds through the recovery of collateral or retention of the right to pursue the debtor for future satisfaction of the debt. The scope of our audit included 435 B-25 write-off cases ($292 million book value) from January 1, 2003 through September 30, 2004.

To test DRR's asset write-off procedures, we reviewed documentation supporting write-off decisions for a sample of 24 asset write-offs ($95 million book value) representing about 33 percent of the $292 million in write-offs for the audit period. Specifically, we determined whether write-off decisions were: approved by officials with the appropriate delegation of authority, adequately supported by corroborating evidence in DRR's Credit Notation System (CNS) and asset files, and reported to the IRS through issuance of Forms 1099-C.

Computer-processed data was not significant to our findings, conclusions, and recommendations; therefore, we were not required to perform assessments of computer-processed data. We used computer-processed data as background information in generating a universe of write-off cases from which to select our sample.

To gain an understanding of internal controls, we reviewed the following documents:

- Federal Deposit Insurance Act;
- DRR's Strategic Plans for 2003 and 2004;
- DRR's *Asset Disposition Manual;*
- the FDIC's delegation of authority resolutions;
- DRR Circular 1160.1, *DRR Senior Management Oversight Committee*;
- FDIC Circular 5400.1, *Reporting for Discharge of Indebtedness (IRS Form 1099)*;
- the FDIC's *Business Events Documentation Guide*;
- minutes of Senior Management Oversight Committee meetings; and
- IRS Bulletins on *Information Reporting Under Section 6050P for Discharge of Indebtedness, Instructions for Forms 1099-A and 1099-C,* and *General Instructions on Use of Form 1120-F to Report Foreign Corporate Income, Gains, Losses, Deductions, and Credits*.

Also, we interviewed officials from DRR's Asset Management Branch, Financial Reporting Group, and Internal Review Group, which are located in Dallas, Texas.

In addition, we reviewed work performed by DRR's Internal Review group. This included quarterly reviews of all actions taken under delegated authority, including asset write-offs, and a DRR Internal Review report dealing specifically with B-25 write-off cases. We reviewed DRR Internal Review's working papers and considered its efforts in designing our audit approach.

We performed our work at the FDIC office in Dallas, Texas, from August 2004 through January 2005. We conducted the audit in accordance with generally accepted government auditing standards.

CORPORATION COMMENTS

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Office of the Director
Division of Resolutions and Receiverships

March 10, 2005

TO: Stephen M. Beard
Deputy Assistant Inspector General for Audits

FROM: Mitchell L. Glassman, Director
Division of Resolutions and Receiverships

[Electronically produced version; original signed by Mitchell L. Glassman]

SUBJECT: Response to Draft Report Entitled *The FDIC's Process for Writing Off Assets (Assignment Number 2004-045)*

This memorandum is in response to the draft audit report entitled, The FDIC's Process for Writing Off Assets (Assignment No. 2004-045). This audit focused on a sample of 24 write-off cases with a book value of $95 million from a universe of 435 cases comprising $292 million in book value.

OIG Audit Recommendations: The draft audit report recommended that the Director, DRR, take the following actions:

(1) Revise FDIC Circular 5400.1, *Reporting for Discharge of Indebtedness (IRS Forms 1099)*, and the supporting manuals to better conform with IRS regulations requiring the issuance of Forms 1099-C.

DRR Response: DRR agrees with the recommendation to revise FDIC Circular 5400.1 Reporting for Discharge of Indebtedness (IRS Forms 1099). It will be revised by a team comprised of DRR Accounting, Legal, DRR Operations (Closing Team Procedures) and DRR Asset Management. A draft of the revised Circular is expected by June 30, 2005.

(2) Issue Forms 1099-C for those write-off cases identified in the report and provided to DRR that had not been reported to the IRS.

DRR Response: DRR partially concurs with this recommendation as outlined in A – C below.

A. DRR agrees with the recommendation with regard to international loans and corporate bankruptcies, and has issued a 1099-C on each of the four international loans and two of the three corporate bankruptcies mentioned in the audit report. Once the REDACTED issue (to be discussed further on the next page) has been resolved, DRR will consider this matter to be closed.

REDACTED MATERIAL

B. DRR disagrees with respect to case REDACTED Name: 4652 Charge Offs, characterized as active charge-offs causing a taxable event with a 1099-C reportable by the receivership. These represent either Type 45 "Other Assets" or Type 70, "Charge Offs" and were booked as a control total and clearly identified as such for tracking purposes. The entries to record the asset as a control total on the receiver's books do not change the status of the loan at failure. The taxable event for the individual loans included in the control total occurred before bank failure, and it is not DRR's policy to send 1099-Cs when the taxable event occurred prior to bank failure. DRR's research on the former bank's Charged-Off Control Total concluded there was not enough information to formally pursue.

C. DRR disagrees with respect to the recommended 1099-C issuance for the following cases:

REDACTED MATERIAL

These assets were clearly identified as "non-assets" meaning no debtor existed and further research was in need to determine the ultimate disposition of the assets. Therefore, there is not a debtor to which to forward a 1099-C.

In the case of REDACTED during our investigation of this transaction (post closing), it was determined that the two "Other Assets" revealed that those related to REDACTED and his wholly owned companies were in dispute [see Section 7.a.(7)(b) of Circular 5400.1 dated May 1, 2001], and ultimately it was determined by Legal that, after offsets and reconciliations, there existed <u>no debt due and no debt forgiven</u>. On the second asset, a Legal review of the documents determined that a joint venture relationship existed, not a loan relationship, and the bank never had an expectation of repayment of a debt.

Neither of these matters, in our opinion, required the issuance of a 1099-C after the assets were written-off. Based on these facts and the certainty that it was the failed institution that initially charged-off these debts prior to closing, DRR did not issue a 1099-C.

(3) Review all write-offs for 2003 and 2004, and issue Forms 1099-C, if appropriate.

DRR Response: DRR agrees with the recommendation and will conduct a review of all write-offs for 2003 and 2004 to ensure compliance with FDIC Circular 5400.1. This review will be completed by June 30, 2005.

cc: Stan Ivie
James R. Wigand
Gail Patelunas
Gary Holloway
Rick Hoffman
Susan E. Whited
Susan Koepp
James H. Angel, Jr.

MANAGEMENT RESPONSE TO RECOMMENDATIONS

This table presents the management response that has been made on the recommendations in our report and the status of the recommendations as of the date of report issuance. The table also reflects information obtained in discussions with management regarding its response.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Monetary Benefits	Resolved:[a] Yes or No	Dispositioned:[b] Yes or No	Open or Closed[c]
1	DRR will draft a revision to FDIC Circular 5400.1 to better conform to IRS regulations.	June 30, 2005	N/A	Yes	No	Open
2	DRR will issue Forms 1099-C for seven of the eight asset write-off cases identified. For the remaining case in which the taxable event occurred before bank failure, DRR requested an opinion from the FDIC's Legal Division on the appropriateness of DRR's policy to not issue Form 1099-C in that circumstance.	September 30, 2005	N/A	Yes	No	Open
3	DRR will conduct a review of all write-offs for 2003 and 2004 to ensure compliance with FDIC Circular 5400.1.	June 30, 2005	N/A	Yes	No	Open

[a] Resolved – (1) Management concurs with the recommendation and the planned corrective action is <u>consistent</u> with the recommendation.
(2) Management does not concur with the recommendation, but planned alternative action is <u>acceptable</u> to the OIG.
(3) Management agrees to the OIG monetary benefits, or a different amount, or no ($0) amount. Monetary benefits are considered resolved as long as management provides an amount.

[b] Dispositioned – The agreed-upon corrective action must be implemented, determined to be effective, and the actual amounts of monetary benefits achieved through implementation identified. The OIG is responsible for determining whether the documentation provided by management is adequate to disposition the recommendation.

[c] Once the OIG dispositions the recommendation, it can then be closed.