

# Office of Inspector General



Office of Audits and Evaluations  
Report No. AUD-15-009

## Controls Over Receivership-Related Federal Income Tax Refunds

**REDACTED VERSION**

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**Portions of this report containing  
sensitive information have been  
redacted and are marked accordingly.**

September 2015



## Why We Did The Audit

The FDIC, as the receiver of failed insured depository institutions, is responsible for maximizing recoveries from the disposition of receivership assets and the pursuit of receivership claims. A significant source of recoveries for receiverships in recent years has been from federal income tax refund claims. Establishing controls to ensure that potential tax refunds are identified and claimed, and that reductions to tax refunds from audits by taxing authorities are minimized, is important for maximizing recoveries for receiverships.

The audit objective was to assess the extent to which FDIC internal controls provide reasonable assurance that management information associated with federal income tax refund claims for receiverships is complete and accurate; responses to Internal Revenue Service (IRS) inquiries are timely; IRS adjustments to tax refund claims are evaluated, accepted and/or appealed in accordance with relevant criteria; and tax refunds are properly recorded on the books and records of the receiverships.

## Background

As of March 31, 2015, the Division of Resolutions and Receiverships (DRR) reported \$4.2 billion in tax refund claims related to failed financial institution receiverships. The tax refund claims have generally been submitted by either the FDIC, or if the situation warrants, by a failed financial institution's holding company on behalf of a consolidated group. Over 97 percent of the reported refund claims (\$4.09 billion) are for federal income taxes while the remaining 3 percent (\$138 million) are for state, territory, or local income taxes.

The receivership-related income tax refund claims are primarily the result of a one-time change in federal tax law that occurred in 2009. Specifically, Congress amended the federal income tax code by enacting Public Law 111-92, the *Worker, Homeownership, and Business Assistance Act of 2009* (WHBAA), which became law on November 6, 2009. The Act allowed most financial institutions and related holding companies a one-time irrevocable election to carry back 2008 or 2009 net operating losses (NOLs) to their prior tax returns for up to a maximum of 5 tax years, rather than the usual 2 tax years. The impact of this change was a large dollar amount of receivership income tax refund claims related to tax years 2003 through 2009. The tax refund windfall resulting from the WHBAA has led to holding companies and related interests asserting legal ownership of all or a portion of the tax refunds. Of the \$4 billion disbursed from taxing authorities for receivership-related tax refunds, almost 66 percent or \$2.8 billion has been distributed to the FDIC, on behalf of receiverships, or to holding companies. The remaining \$1.2 billion is generally being held in escrow until legal ownership of the monies is determined.

DRR's Tax Department manages receivership-related tax activities, which include preparing receivership tax returns; filing refund claims; responding to IRS information requests for audits of refund claims; evaluating, accepting or appealing IRS denied tax refund decisions; and ensuring that tax refunds are properly recorded in the receivership's books and records. DRR uses the Tax Track system to maintain an inventory of all income tax returns and monitor the status of tax refund claims, estimate potential tax refund recoveries, and summarize and report key program information to DRR senior management. To accomplish its many responsibilities, the DRR Tax Department must coordinate with multiple groups both internal and external to the FDIC. Internal coordination is primarily with the FDIC's financial institution closing teams to obtain relevant failed financial institution tax records, and the Legal Division

to help manage disputes between the FDIC, as Receiver, and a holding company over ownership of tax refunds. The DRR Tax Department also interacts with external parties, primarily a failed financial institution's holding company, third-party Certified Public Accountant firm, and assuming institution and with the IRS and state taxing authorities to obtain records needed to prepare and file tax returns with, or to respond to audits by, taxing authorities.

## **Audit Results**

In general, we found that the FDIC had properly recorded \$2.1 billion in receivership federal income tax refunds collected from the IRS, \$50.6 million in interest received on those refunds, and \$45.3 million in uncollected federal income tax refunds for the receiverships that we reviewed. We also found that the DRR Tax Department made significant improvements in its procedures, processes, and training and had initiated a multi-year tax research project to ensure that all recoverable tax refunds have been pursued. In addition, DRR had worked to enhance tax policy and guidelines in situations where ownership of the tax refund was in dispute with the holding company or where the IRS disallowed deductions for estimated selling costs. Notwithstanding these accomplishments, our audit identified further opportunities for DRR to improve controls and guidance. Specifically, we found that the FDIC could:

- Enhance guidance for recording, and maintaining the reliability of, tax refund claim-related information in the Tax Track system;
- Better track and document responses to IRS inquiries and more consistently record activities performed to evaluate and accept, or appeal, IRS tax audit adjustments; and
- Improve procedures for recording potential tax refund recoveries in the receivership records.

Limited DRR Tax Department staff resources were a contributing factor to our findings. In that regard, we brought that issue to management's attention in separate correspondence during the course of our audit as the FDIC continues to reduce resources in this area. Accordingly, we are not making recommendations to address that aspect of our findings in this report. Finally, we had observations related to controls over sensitive tax and personally identifiable information maintained by DRR, automated tools used to prepare annual income tax returns, and obtaining IRS account transcripts. We reported these matters separately to FDIC management because, in the case of the first two, they were not considered significant in the context of our audit objective. The third matter involved sensitive information not appropriate for public disclosure.

## **Recommendations and Corporation Comments**

This report includes five recommendations addressed to the Director, DRR that are intended to improve the FDIC's controls over receivership-related income tax refund claims. Our report also identified \$4.6 million in funds put to better use. The Director, DRR, provided a written response, dated September 3, 2015, to a draft of this report. In the response, the Director concurred with all five of the report's recommendations and described planned and completed actions that were responsive to the recommendations. With respect to the funds put to better use, DRR collected approximately \$140,000 during our audit, researched and determined that a significant portion was not recoverable, and agreed to develop approaches for resolving what remained outstanding.

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**DATE:** September 21, 2015

**MEMORANDUM TO:** Bret D. Edwards, Director  
Division of Resolutions and Receiverships

**FROM:** */Signed/*  
Mark F. Mulholland  
Assistant Inspector General for Audits

**SUBJECT:** *Controls Over Receivership-Related Federal Income Tax Refunds (Report No. AUD-15-009)*

The FDIC, as the receiver of failed insured-depository institutions, is responsible for maximizing recoveries from the disposition of receivership assets and the pursuit of receivership claims. A significant source of recoveries for receiverships in recent years has been from federal income tax refund claims. Establishing controls to ensure that potential tax refunds are identified and claimed, and that reductions to tax refunds from audits by taxing authorities are minimized, is important for maximizing recoveries for receiverships.

The audit objective was to assess the extent to which FDIC internal controls provide reasonable assurance that management information associated with federal income tax refund claims for receiverships is complete and accurate; responses to Internal Revenue Service (IRS) inquiries are timely; IRS adjustments to tax refund claims are evaluated, accepted, and/or appealed in accordance with relevant criteria; and tax refunds are properly recorded on the books and records of the receiverships.

We conducted this performance audit in accordance with generally accepted government auditing standards. Appendix 1 of this report includes additional details on our objective, scope, and methodology. Appendix 2 contains a glossary of key terms,<sup>1</sup> Appendix 3 contains a list of acronyms and abbreviations, Appendix 4 contains the Corporation's comments on this report, and Appendix 5 contains a summary of the Corporation's corrective actions.

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<sup>1</sup> Certain terms that are underlined when first used in this report are defined in Appendix 2, *Glossary of Terms*.

## Background

As of March 31, 2015, the Division of Resolutions and Receiverships (DRR) reported \$4.2 billion in tax refund claims related to failed financial institution receiverships.<sup>2</sup> The tax refund claims have generally been submitted by either the FDIC, or if the situation warrants, by a failed financial institution's holding company on behalf of a consolidated group. Over 97 percent of the reported refund claims (\$4.09 billion) are for federal income taxes, while the remaining 3 percent (\$138 million) are for other taxes, including state,<sup>3</sup> territory, or local income taxes.

### Federal Income Tax Refund History

The significant dollar amount of receivership-related federal income tax refund claims is primarily the result of a one-time change in federal tax law that occurred in 2009. Specifically, the Congress amended the federal income tax code<sup>4</sup> by enacting Public Law 111-92, the *Worker, Homeownership, and Business Assistance Act of 2009* (WHBAA), which became law on November 6, 2009. The Act allowed certain businesses, including most financial institutions and related holding companies, a one-time irrevocable election to carry back 2008 or 2009 net operating losses (NOLs) to their prior tax returns for up to a maximum of 5 tax years. Generally, businesses may only carry back NOLs up to 2 tax years. As shown in the following figure, the impact of this change was a large dollar amount of receivership income tax refund claims related to tax years 2003 through 2009.

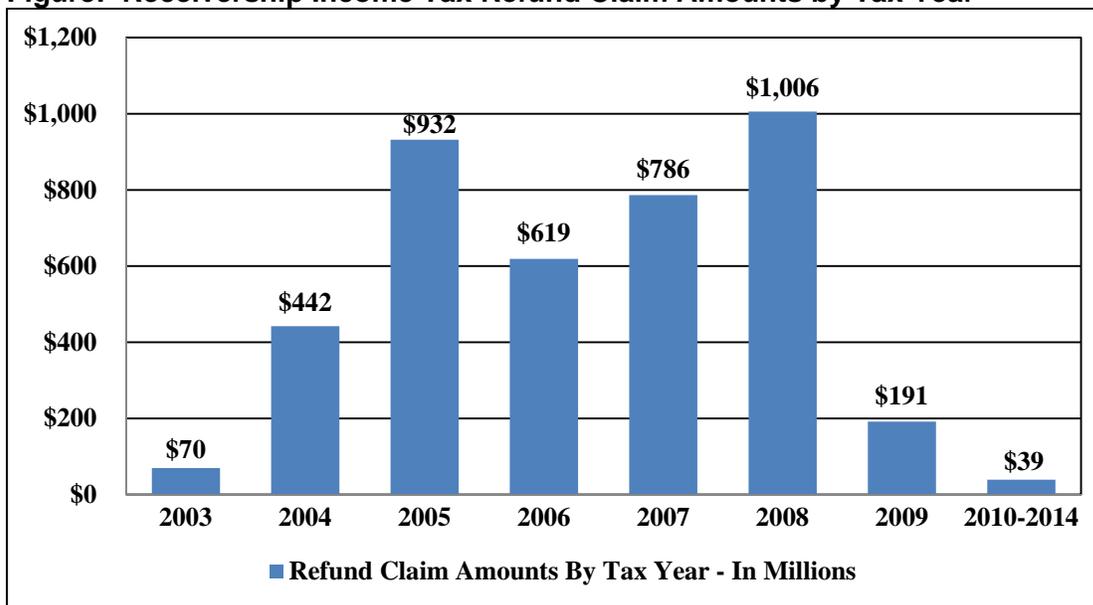
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<sup>2</sup> This amount reflects only those tax refund claims for active receiverships that are being, or have been, pursued for collection subsequent to financial institution failure.

<sup>3</sup> Although state income tax refund claims were not part of our scope, information about such claims came to our attention during the course of this audit. We noted that under Section 15(b)(1) of the Federal Deposit Insurance Act (the FDI Act) (12 United States Code (U.S.C.) § 1825(b)(1)), the FDIC as Receiver is exempt from paying state and local income and franchise taxes, but DRR will file the related tax returns to claim tax carrybacks or to comply with state franchise requirements, for example.

<sup>4</sup> The federal income tax code is the Internal Revenue Code (IRC) of 1986, which can be found at Title 26 of the U.S.C. Throughout this report, when referring to the federal income tax code, we will cite the appropriate section of the IRC.

**Figure: Receivership Income Tax Refund Claim Amounts by Tax Year**



Source: OIG summary of tax refund claims information contained in the Tax Track *Refund Analysis – Active Receiverships* report as of March 31, 2015.

Note: Tax years 2008 and 2009 included \$824 million and \$86 million, respectively, in tax refund claims for two receiverships that were the result of settlement agreements with holding companies. Tax Track reflects these settlement amounts in the applicable WHBAA NOL election year, rather than the carryback years 2003 to 2007.

### **DRR Tax Department**

The FDIC’s receivership-related tax activities are managed primarily by the DRR Tax Department, which is comprised of tax professionals located in Dallas, Texas; Sacramento, California; and Arlington, Virginia. Among other duties, the DRR Tax Department is responsible for preparing receivership federal, state, and local tax returns; filing claims for refunds; responding to IRS information requests for audits of tax refund claims; evaluating, accepting or appealing IRS decisions that result in denied tax refunds; and ensuring that tax refunds are properly recorded in the respective receivership’s books and records. DRR records indicate that, in calendar year 2014, the DRR Tax Department was involved in completing 855 federal and state income tax returns on behalf of FDIC receiverships.

DRR managers informed us that during the early years of the recent financial crisis, the DRR Tax Department had only two permanent full-time Tax Accountants. Subsequently, the DRR Tax Department grew to include as many as 26 personnel; however, it is currently downsizing in response to a reduction in financial institution failures. Within the DRR Tax Department, the Tax Manager and three other tax professionals make up the tax audit team, which specializes in addressing IRS tax audit issues.

To accomplish its many responsibilities, the DRR Tax Department must coordinate with multiple groups both internal and external to the FDIC. Internal coordination is primarily with the FDIC’s financial institution closing teams and the Legal Division. A Tax Accountant participates on a closing team to obtain relevant failed financial institution

tax records. The Legal Division manages disputes between the FDIC, as Receiver, and a holding company over ownership of tax refunds. DRR Tax Department personnel help negotiate settlements, participate in mediations, deliver testimony as a witness at depositions, and provide the Legal Division with documents that support the FDIC's claim to the tax refund. The department also supports the Legal Division in monitoring tax refund amounts held in escrow or reserve accounts<sup>5</sup> until ownership of the tax refund is determined.

The DRR Tax Department also interacts with external parties, primarily a failed financial institution's holding company, third-party Certified Public Accountant (CPA) firm, and assuming institution and with the IRS and state taxing authorities. The purpose of this coordination is generally to obtain records needed to prepare and file tax returns with, or to respond to audits by, taxing authorities. In situations where a holding company has filed for bankruptcy, department personnel consult with the Legal Division for guidance on interaction with the holding company and taxing authorities, as such contact may need to involve a bankruptcy trustee.

### **IRS and FDIC Roles and Responsibilities in the Tax Audit Process**

The IRS has authority under IRC § 7602(a), to examine federal income tax returns filed by taxpayers, including financial institutions. When a financial institution fails, the FDIC notifies the IRS that the FDIC is the fiduciary for the failed financial institution. As such, federal income tax returns filed by, or on behalf of, the FDIC as Receiver are subject to IRS examination.

The IRS conducts two levels of examinations – a survey, which involves a limited review of the return, or an audit, which involves a detailed review of the return and taxpayer records supporting the return. The IRS may elect to examine receivership-related federal income tax returns from either before or after a financial institution closes and can choose to coordinate the examination with either the FDIC as Receiver, the holding company of the failed financial institution, or both as the taxpayer subject to examination. In situations where a holding company has filed for bankruptcy, coordination with the IRS is generally led jointly by representatives of the holding company, such as a bankruptcy trustee, and the tax audit team.

IRS revenue agents from the IRS' Large Business and International (LB&I) Division perform the tax audits of receivership federal income tax returns. An IRS tax audit begins with notification to the taxpayer, followed by Information Document Requests (IDRs) that seek specific information needed by the IRS to perform the tax audit. After reviewing the requested information, the IRS summarizes the tax audit results in a Revenue Agent Report (RAR) that is provided to the taxpayer. As a result of the tax audit, the IRS may

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<sup>5</sup> Such accounts are referred to collectively as escrow accounts throughout this report. In some cases, a tax refund and related interest is collected by the FDIC, the holding company, or a trustee and is placed in an escrow account because ownership of the refund is disputed. The refund remains in the escrow account until there is either a settlement between the competing parties (generally the FDIC as Receiver and the holding company), or a court order is issued determining the disbursement of the funds held.

deny all or a portion of a tax refund claim. The taxpayer may either accept or appeal the IRS decision. If the IRS decision is appealed by the taxpayer, the IRS may agree or disagree with the taxpayer's position as a result of the appeals process. Regardless of whether or not the IRS audit decision is appealed, the IRS must submit information about all federal tax refunds in excess of certain thresholds<sup>6</sup> to the congressional Joint Committee on Taxation prior to payment of the refund to the taxpayer.

The DRR Director has delegated authority to the Tax Manager and the tax audit team leader to handle all tax-related matters, which includes unlimited authority to accept or appeal IRS tax audit results. The tax audit team is responsible for coordinating, managing, and executing the FDIC response to IRS tax audits, with assistance from other DRR Tax Department personnel, and the FDIC's Legal Division, including bankruptcy and tax attorneys, and outside counsel. As needed, the tax audit team may coordinate with the assuming institution, the failed financial institution's CPAs, or the holding company to obtain records related to the tax refund claim, such as prior tax returns or documents supporting asset losses.

In addition to coordinating access to information for the IRS tax audit, the tax audit team assists the IRS revenue agents with sampling and on-site reviews of failed institution loan files to support bad debt expense deductions on tax returns, and reviews the support for potential loan-level tax audit adjustments with the IRS revenue agents as the adjustments arise. The tax audit team members informally discuss the final tax audit adjustments among themselves, and others as appropriate, and collectively decide whether to accept or appeal the IRS results. If accepted, one of the two tax audit team members with delegated authority signs and submits a form to the IRS indicating FDIC acceptance of the tax audit results.<sup>7</sup> If not accepted, the tax audit team prepares a letter outlining the issues it wishes to appeal.

### **Ownership and Recording of Tax Refunds Collected**

A consequence of the tax windfall resulting from the WHBAA was that holding companies and related interests have asserted legal ownership of all or a portion of the tax refunds collected from taxing authorities. The basis for these assertions was often a tax sharing agreement between a financial institution and its holding company. These tax sharing agreements can address certain issues common to consolidated groups, such as the method for allocating income tax-related payments and refunds among members of the group, but were sometimes unclear. In disputes regarding the ownership of tax refunds, some courts have found that tax refunds generated by a financial institution were the property of its bankrupt holding company, based on certain language in their tax sharing agreements that the courts interpreted as creating a debtor-creditor relationship.

Of the \$4 billion disbursed from taxing authorities for receivership-related tax refunds, almost 66 percent or \$2.8 billion has been distributed to the FDIC, on behalf of the

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<sup>6</sup> The thresholds are currently \$5 million for C-Corporation taxpayers, including receiverships, and \$2 million for all other taxpayers. Prior to December 19, 2014, the threshold was \$2 million for all taxpayers.

<sup>7</sup> For tax audits involving receivership tax returns, this acceptance may be documented on IRS Form 870, *Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment*.

receivership, or to a holding company. The remaining \$1.2 billion is generally being held in escrow until legal ownership of the monies is determined. The table below provides an overview of the current status of receivership income tax refund claims.

**Table: Disposition of Income Tax Refund Claims as of March 31, 2015**

<b>Disposition of Income Tax Refund Claims</b>	<b>Claim Amounts (in Millions)</b>	<b>Percentage of Total Claims</b>
Collected from the IRS or Other Taxing Authority and:		
Distributed Between the FDIC and a Holding Company	\$2,770	65.6%
Held in Escrow Accounts Pending Ownership Determination	\$1,217	28.8%
Held by a Holding Company Pending Ownership Determination	\$ 20	0.5%
<b>Total Collected from the IRS or Other Taxing Authority</b>	<b>\$4,007</b>	<b>94.9%</b>
Pending Payment by the IRS or Other Taxing Authority	\$ 94	2.2%
Payment Denied by the IRS or Other Taxing Authority	\$ 123	2.9%
<b>Total Income Tax Refund Claims</b>	<b>\$4,224*</b>	<b>100%</b>

Source: OIG summary of tax refund information contained in the Tax Track *Refund Analysis – Active Receiverships* report as of March 31, 2015.

\*Excludes interest of approximately \$120 million collected from taxing authorities on refund claims.

### **Tax Refund-Related Information Systems and Records**

DRR uses the Tax Track system to maintain an inventory of income tax returns, refunds, and tax audits for receiverships. DRR personnel generate periodic reports from this system for the purposes of monitoring the status of tax refund claims, estimating potential tax refund recoveries, and summarizing and reporting key program information to DRR senior management. The DRR Tax Department maintains forms, correspondence, and other official records for the tax refund program in a secured file room, on the DRR Tax Department network shared drive, or in individual employee Outlook® email folders.

DRR uses the FDIC’s New Financial Environment (NFE) general ledger system to record certain tax refund-related amounts in the books and records of the receiverships. DRR generally records tax refund collections distributed to and deposited with the FDIC as income to receivership general ledger account 4510 *Tax Refund Collections*. In addition, DRR records a monthly estimate of potential tax refund recoveries by a receivership, reflecting refunds held in escrow and refunds pending payment by taxing authorities, to receivership general ledger memorandum account M1290 *Tax Refunds – Possible* (account M1290).<sup>8</sup>

### **Internal Control and Transaction Documentation Requirements**

The Government Accountability Office (GAO) and the FDIC have issued a number of overarching internal control and transaction documentation requirements, including the *GAO Standards for Internal Control in the Federal Government*<sup>9</sup> and FDIC Circular

<sup>8</sup> The FDIC uses memorandum accounts to identify amounts that are subject to one or more contingencies. Since tax refunds are not fixed and determinable and may be subject to audit, these refunds are generally not recognized until they are received and deposited with the FDIC. The month-end amount in account M1290 is reflected in a notation on the balance sheet of the monthly receivership financial statements.

<sup>9</sup> GAO-14-704G, dated September 2014, and GAO/AIMD-00-21.3.1, dated November 1999.

4010.3, *FDIC Enterprise Risk Management Program*. These standards and policies require that internal controls, all transactions, and other significant events be clearly documented, and that the documentation should be readily available for examination. The GAO explains that effective documentation establishes and communicates the who, what, when, where, and why of internal control execution to personnel. Effective documentation also provides a means to retain organizational knowledge and mitigate the risk of having that knowledge limited to a few personnel, as well as a means to communicate that knowledge as needed to external parties, such as external auditors.

Circular 4010.3 also requires divisions and offices to maintain current and appropriately documented policies and procedures. In addition, FDIC Circular 1210.1, *FDIC Records and Information Management (RIM) Policy Manual*, requires the FDIC to maintain proper documentation of its operations to provide current and historical data pertaining to actions taken by the FDIC in its role as receiver for failed financial institutions. It further requires the FDIC to apply appropriate recordkeeping practices when creating, naming, filing, and transferring business records.

## **Audit Results**

As of March 31, 2015, DRR reported \$4.2 billion in tax refund claims related to failed financial institution receiverships. In general, we found that the FDIC properly recorded receivership federal income tax refunds collected from the IRS, interest received on those refunds, and uncollected federal income tax refunds for the receiverships that we reviewed. We also found that the DRR Tax Department made significant improvements in its procedures and processes, and took other actions designed to maximize tax refund recoveries for receiverships and the Deposit Insurance Fund (DIF) since the beginning of the recent financial crisis.

Notwithstanding these accomplishments, our audit identified further opportunities for DRR to improve controls and guidance in this area. The enhanced guidance and other corrective actions that we are recommending are intended to help the FDIC reduce the financial risks associated with unrecovered tax refunds and reputational risks associated with incomplete documentation of its IRS tax audit-related activities. The FDIC also needed to complete actions in process to address one recommendation that identifies \$4.6 million in funds put to better use. This amount is related to the untimely follow-up on \$4.3 million of potential federal income tax recoveries that were not recorded in Tax Track and almost \$275,000 in tax refund checks that needed to be reissued to the receivership.

Limited DRR Tax Department staff resources were a contributing factor to our findings. In that regard, we brought that issue to management's attention in separate correspondence during the course of our audit as the FDIC continues to reduce resources in this area. Accordingly, we are not making recommendations to address that aspect of our findings in this report. Finally, we had observations related to controls over sensitive tax and personally identifiable information maintained by DRR; automated tools used to

prepare annual income tax returns; and obtaining IRS account transcripts. We reported these matters separately to FDIC management because, in the case of the first two, they were not considered significant in the context of our audit objective. The third matter involved sensitive information not appropriate for public disclosure.

## **DRR Generally Recorded Tax Refunds Received Properly and Took Significant Steps to Improve Controls Designed to Maximize Recoveries**

We reviewed \$2.1 billion in receivership federal income tax refunds collected from the IRS, \$50.6 million in interest received on those refunds, and \$45.3 million of federal income tax refund claims that the FDIC was in the process of collecting from the IRS. In general, we found those amounts to be properly recorded in the books and records of the receiverships.

We also found that the DRR Tax Department made significant improvements in its procedures and processes, and took other actions designed to maximize tax refund recoveries for receiverships and the DIF since the beginning of the recent financial crisis. Of note, DRR:

- Developed and implemented a revised *Receivership Tax Manual* with related Exhibits and Job Aids (Tax Manual), which was most recently updated in October 2014. Among other controls, this guidance established:
  - A *Refund Analysis* worksheet review by the Tax Manager to ensure potential tax refund recoveries for a receivership are identified and pursued; and
  - A *Tax Closing Checklist* to identify key documents that should be collected in order to improve the FDIC's ability to respond timely and completely to IRS inquiries.
- Developed a training presentation, *Defending IRS and State Audits*, for use by DRR Tax Accountants that explains the IRS tax audit process and the types of significant adjustments experienced on receivership tax audits. This training, implemented in response to a significant receivership tax refund reduction, was designed to identify strategies for evaluating and responding to certain types of IRS tax audit adjustments.
- Participated in an interagency effort that resulted in the financial regulators' 2014 Addendum<sup>10</sup> to the *Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure*, dated November 5, 1998. The changes made to

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<sup>10</sup> The Addendum, dated June 19, 2014 (79 Federal Register 35229), was issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC.

this policy statement were designed to enhance the ability of a receivership to recover tax refunds in situations where ownership of the tax refund is disputed by the holding company. Specifically, the 2014 Addendum indicated that tax sharing agreements should contain language clearly establishing a trust relationship between a financial institution and its holding company, not a debtor-creditor relationship, and reiterated the Policy Statement's provision that the financial institution be treated no less favorably than if it had filed tax returns on a separate return basis.

- Challenged IRS tax audit adjustments that disallowed deductions related to estimated selling costs, and participated in a government/private sector effort that led to the issuance, in October 2014, of IRS guidance regarding the treatment of those costs for tax purposes. Specifically, the *LB&I Directive Related to § 166 Deductions for Eligible Debt and Eligible Debt Securities*<sup>11</sup> indicated, among other things, that the IRS will not challenge the inclusion of certain estimated selling costs in a bank's bad debt deduction. The directive allows for amendments of certain previously filed returns, contains time limits for claiming adjustments, and is subject to further guidance in the future.
- Initiated a multi-year tax research initiative, starting in late 2010, to review each receivership to determine whether all recoverable tax refunds have been pursued.

## **DRR Has Opportunities to Improve Controls and Guidance**

DRR accomplishments in collecting tax refund claims on behalf of FDIC receiverships have been commendable. However, we determined that DRR's tax operations could benefit from enhanced controls and guidance for: (1) recording and maintaining the reliability of tax refund information in Tax Track; (2) recordkeeping related to IRS inquiries and responses; (3) documenting decisions regarding IRS tax audit adjustments; and (4) identifying and recording estimates of potential tax refund recoveries. GAO internal control standards and FDIC circulars emphasize the importance of reliable data, adequate procedures, and documented transactions. Implementing our suggested control enhancements will provide DRR management with increased assurance that their expectations have been appropriately communicated, and that the work is performed in accordance with such expectations.

### **Recording and Maintaining the Reliability of Tax Refund Information in Tax Track**

We reviewed the reliability of six key data elements<sup>12</sup> in the Tax Track system for selected federal income tax refund claims associated with a non-statistical sample of 52 receiverships. The GAO's *Assessing the Reliability of Computer Processed Data*<sup>13</sup>

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<sup>11</sup> LB&I-04-1014-008, dated October 24, 2014.

<sup>12</sup> We tested the refunds applied for, refunds collected, refund-related interest, refunds denied, refunds-in-process of collection, and refund status data elements, which are the basis of the management information communicated in Tax Track refund-related reports.

<sup>13</sup> GAO-09-680G, dated July 2009.

guidance defines data reliability as data that are both reasonably complete and accurate. We considered the refund claim information to be reasonably complete if the tax refund claims selected for review were recorded in Tax Track. We considered the information to be accurate if the tax refund claim information for each tested data element was correct.

For six receiverships, we found a total of eight refund claims that had not been recorded in Tax Track, causing refunds applied for amounts to be understated by \$16.5 million. For 14 receiverships, we found one or more refund claims with data, primarily those related to refunds applied for, refunds denied and refund status, that were inaccurate, causing refunds applied for amounts to be overstated by \$31.5 million. Although the discrepancies we found were not significant to the total refund claims managed by the DRR Tax Department, management information related to refunds denied did not provide an accurate status of the program's results as of the audit date. Certain Tax Track discrepancies also resulted in a misstatement of the estimated potential recoveries recorded in account M1290, and the notations reflected on the related receivership's balance sheet, as of July 31, 2014. We brought these discrepancies to the attention of DRR Tax Department personnel, who updated Tax Track to address the discrepancies, which also resulted in corrections to account M1290.

Guidance in the Tax Manual and related Job Aids for recording federal income tax refund claim information in Tax Track did not sufficiently define certain data elements, such as refunds applied for and refunds denied, or clearly indicate DRR management's expectation that all tax refund claims should be entered into Tax Track when identified, even if recovery by the FDIC was uncertain. In some instances, discrepancies caused by data entry errors or the untimely recording of information in Tax Track may not have been detected by DRR monitoring procedures, such as independent data reviews or reconciliations to the NFE general ledger, due to limited staff resources in prior years.

The omission of refund claims for two receiverships from Tax Track may have limited timely follow-up by DRR personnel to determine the collectability of the tax refund claims. At the time of our fieldwork, the DRR Tax Department records for one receivership with a potential tax refund recovery of *\$redacted* did not reflect any significant follow-up on the tax refund claims since August 2013. The DRR Tax Department records for the other receivership, with a potential tax refund recovery of *\$redacted*, did not identify any significant follow-up on the tax refund claim since the financial institution failed in 2009. Subsequent DRR research on one of the potential refund claims identified an additional unrecorded tax refund claim of *\$redacted*. At the end of our fieldwork, DRR research into the collectability of these tax refund claims, totaling \$4.3 million, was ongoing.

### **Recordkeeping for IRS Inquiries and Responses**

Due to DRR's recordkeeping practices, and the lack of a system for tracking IRS IDRs and associated responses, we were unable to conclude on the timeliness of FDIC's responses to IRS inquiries. However, we found no evidence to suggest that any reductions in tax refund recoveries as a result of IRS tax audit adjustments were the result of untimely responses to IRS inquiries. Nonetheless, establishing additional

recordkeeping guidelines and a tool for tracking progress on responding to IRS inquiries, would provide greater assurance that FDIC responses to IRS IDRs are timely and thus help to minimize the risk of IRS making unnecessary tax audit adjustments that reduce tax refund recoveries to a receivership. Such actions may also reduce reputational risk because FDIC policy requires that DRR maintain proper documentation of its operations.

To assess the timeliness of FDIC's responses to IRS IDRs, we selected a non-statistical sample of five receiverships involved in IRS tax audits conducted between November 2008 and July 2014. At the time of our audit, DRR's recordkeeping for the tax audit process included a large volume of Outlook® emails. Therefore, we relied on the tax audit team leader to identify the most significant IRS tax audit-related email correspondence for the five sampled receiverships. In addition, we reviewed tax audit-related correspondence that was captured in hard copy documents stored in a secured file room or in electronic documents stored on a DRR Tax Department network shared drive.

Our initial review of the available IRS tax audit-related correspondence did not find consistent identification or tracking of the receipt of the IDRs, the due date for the responses, or the actual response dates. Because DRR did not have an automated tool or system for IDR and associated response tracking, it was difficult in some instances to determine whether DRR personnel had in fact responded timely to the IRS request. Further, the tax audit team leader informed us that limited staff resources available for the tax audit process in prior years lowered the priority of documenting the activities performed. DRR email records have also been inadvertently deleted or could not be readily recovered due to the Outlook® email archiving process. As a result, the record of receivership-related tax audit activity was incomplete.

Although DRR updated the Tax Manual on October 28, 2014 to assign responsibility for documenting relevant tax audit-related communication and created a new Job Aid that established recordkeeping controls for hard copy tax documents, these guidelines did not adequately address the use and storage of electronic records, including emails. In addition, DRR could further enhance the IDR response process by establishing a log to track the IDRs received, the related responses, the individuals responsible for responding, and key milestone dates.

### **Documenting Decisions Regarding IRS Tax Audit Adjustments**

Many receivership-related federal income tax refunds have been subject to audit, and in some cases adjustment, by the IRS. While DRR personnel had taken action to evaluate and accept or appeal IRS tax audit adjustments that we reviewed, the actions taken and the basis for the decisions were not consistently documented. DRR generally had established limited policies and procedures to guide the IRS tax audit evaluation process, and instead relied on the experience and skill of the tax audit team. In a downsizing environment, DRR management has reduced assurance that the collective knowledge of the tax audit team will be retained and that future tax audit evaluation activities will be performed in accordance with management expectations. Improved recordkeeping may also reduce reputational risk, by enhancing DRR's ability to meet its responsibility to maintain proper documentation.

To assess DRR's practices for evaluating and accepting or appealing IRS tax audit results, we selected a non-statistical sample of eight receiverships with IRS tax audits conducted between November 2008 and July 2014. For all of our sampled receiverships, the tax audit team leader provided an overview of the nature of the IRS tax audit adjustments and the types of activities performed by the tax audit team to evaluate those adjustments. The IRS tax audit adjustments were primarily the result of failed financial institution records that did not adequately support certain expenses included in, or certain income excluded from, income tax refund claims. We found the tax audit team leader to be knowledgeable of the circumstances and status of each IRS tax audit we reviewed.

In many cases, we found evidence of FDIC evaluation activities by reading available emails between FDIC personnel, IRS revenue agents, and other third parties such as CPA firms and holding company personnel. We also found references to FDIC activities in the documents provided by the IRS to support the tax audit adjustments identified in the RAR. However, the documentation supporting the extent of the activities performed and decisions made varied from a written case prepared to support a decision to accept the tax audit adjustments that reduced refunds for one receivership by \$15.9 million, to no formal records documenting the extent of evaluation activities and support for decisions made for the other seven receiverships. In two instances we were unable to determine the extent of the activities DRR personnel had performed to evaluate two IRS tax audit adjustments that totaled \$35.2 million.

As noted earlier, DRR personnel indicated that staff resources available for documenting tax audit-related activities in prior years were limited. In addition, we found that the Tax Manual did not outline the process for evaluating IRS tax audit results or the requirements for documenting the analyses that support FDIC's decisions to accept those results. The tax audit team leader informed us that the process for vetting the decisions made was generally conducted verbally or through email among the tax audit team members, because the tax audit team included two employees with delegated authority for all tax matters. We also found that DRR personnel did not consistently use Tax Track to record current status information regarding IRS tax audits.

### **Identifying and Recording Estimates of Potential Tax Refund Recoveries**

As noted earlier in this report, we reviewed \$2.1 billion in receivership federal income tax refunds collected from the IRS, \$50.6 million in interest received on those refunds, and \$45.3 million of federal income tax refunds that the FDIC was in the process of collecting from the IRS. In general, we found those amounts to be properly recorded in the books and records of the receiverships. However, DRR's process for identifying and recording an estimate of potential tax refund recoveries in account M1290 did not include (i) \$11.7 million in federal tax refunds collected by the failed financial institution's holding company<sup>14</sup> after closing that the FDIC may be able to recover or (ii) federal tax refund checks totaling \$181,580 returned to a taxing authority for reissuance. Excluding

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<sup>14</sup> If a receivership is part of a consolidated group, the IRS has the option of sending tax refund checks to either the holding company, the FDIC as Receiver, or both.

these tax refunds can understate the potential tax refund recoveries reflected in notational information appearing in the receivership monthly financial statements.

In addition, we found that DRR did not ensure timely follow-up on two tax refund checks returned to the IRS for reissuance, one in November 2012 and the other in March 2013. As of August 2014, neither of the tax refund checks had been reissued to the FDIC, nor did the DRR Tax Department files reflect any recent follow-up regarding the delay. We brought this issue to DRR management's attention in September 2014, and DRR Tax Department personnel subsequently contacted the IRS to research the status of these checks, and also followed up on seven state tax refund checks totaling \$236,533.<sup>15</sup>

DRR research determined that one state tax refund totaling \$143,230 had been received and deposited by the FDIC in 2011, but the collection was recorded incorrectly in Tax Track. In October 2014, DRR received and deposited a new tax refund check for one of the federal tax refunds. For the other federal tax refund for \$41,061, the IRS informed DRR that the check had been cashed by the holding company, indicating the IRS reissued the check to the holding company rather than to the FDIC. At the end of our fieldwork, DRR Tax Department personnel were attempting to determine whether this federal tax refund, as well as the six other state tax refunds totaling \$93,303, could be recovered by the applicable receiverships. Prompt follow-up on tax refund checks sent to taxing authorities for reissuance may provide greater assurance that tax refunds are recovered by receiverships in a timely manner.

## **Recommendations**

We recommend that the Director, DRR:

1. Enhance DRR procedures to more clearly define the (1) income tax refund claim-related amounts that should be recorded in Tax Track and (2) requirements for data reliability reviews and reconciliations between Tax Track and the NFE general ledger.
2. Enhance DRR procedures to incorporate guidelines for the tax audit response process; and the electronic and other records that should be retained to evidence the activities performed to respond to IRS inquiries, evaluate tax audit results, and document the bases for the decisions made to accept or appeal those results.
3. Enhance DRR procedures to ensure that (1) an estimate of all potential tax refund recoveries for a receivership is recorded in the receivership general ledger and (2) tax refund checks that have been sent to a taxing authority for reissuance are monitored and resolved in a timely manner.

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<sup>15</sup> As noted earlier in the report, our audit scope as defined in Appendix 1 did not specifically include an assessment of state tax refunds. However, we are identifying these refunds because they came to our attention during the course of our work.

4. Evaluate options for using an automated system or tool to document, track, and report tax audit-related activities, such as information document requests and responses to those requests.
5. Develop a plan to complete follow-up efforts associated with (1) \$4,311,139 of potential federal income tax refund recoveries and (2) \$134,364 of refund checks received and then returned to a taxing authority for reissuance. [Funds put to better use of \$4,586,022, to include \$140,519 recovered during the course of our audit, and \$4,445,503 that the FDIC was in the process of collecting.]

## Corporation Comments and OIG Evaluation

The Director, DRR, provided a written response, dated September 3, 2015, to a draft of this report. The response is presented in its entirety in Appendix 4. In the response, the Director concurred with all five of the report's recommendations. With respect to Recommendation 5, DRR has taken or planned corrective actions regarding income tax refund-related amounts totaling \$4,586,022, identified in our report as funds put to better use. Specifically, DRR:

- collected \$140,519 during the course of our audit;
- completed follow-up efforts on *\$redacted* of potential tax refunds and provided documentation supporting that this amount is not collectable; and
- will develop memorandums that describe the approach for collecting or resolving \$1,262,408 of potential tax refunds and \$134,364 of tax refund checks received and then returned to a taxing authority for reissuance.

A summary of the Corporation's corrective actions is presented in Appendix 5. The completed and planned actions are responsive to the recommendations and the recommendations are resolved.

## Objective, Scope, and Methodology

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### Objective

Our audit objective was to assess the extent to which FDIC internal controls provide reasonable assurance that (1) management information associated with federal income tax refund claims for receiverships is complete and accurate; (2) responses to Internal Revenue Service (IRS) inquiries are timely; (3) IRS adjustments to tax refund claims are evaluated, accepted and/or appealed in accordance with relevant criteria; and (4) tax refunds are properly recorded on the books and records of the receiverships.

We conducted this performance audit from April 2014 to April 2015 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. We caution that projecting the results of our audit to future periods is subject to the risk that controls may become inadequate because of changes in conditions or because compliance with controls may deteriorate.

### Scope and Methodology

The scope of this audit included federal income tax refund claims for receiverships established between January 1, 2007 and December 31, 2013. For each audit sub-objective, we assessed whether controls were in place and functioning as designed as of July 31, 2014.

To achieve the objectives, we performed the following procedures and techniques:

- Identified and reviewed the primary criteria used by the DRR Tax Department to guide its activities, specifically the *Receivership Tax Manual* and related Exhibits and Job Aids. We also reviewed and considered other FDIC and DRR directives or guidelines as appropriate.
- To obtain an understanding of other procedures that the FDIC had established and implemented relevant to the audit objective, we:
  - attended the DRR Tax Department presentation during the 2014 DRR Accounting Conference on May 7, 2014;
  - interviewed DRR Tax Department and Legal Division personnel who had responsibility for designing, implementing, and reviewing controls relevant to federal income tax refund claims and related information systems;
  - reviewed the DRR Internal Review report entitled, *Receivership Tax Review – DRR 2011-092*, dated February 24, 2012 and supporting work papers;
  - selected a non-statistical sample of one receivership and walked through the tax return preparation process and related tax files with the responsible DRR Tax Accountant; and

## Objective, Scope, and Methodology

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- for the same judgmentally sampled receivership, we walked through the federal income tax refund claim settlement process and settlement-related documents with the Legal Division subject matter expert.
- To obtain an understanding of management information relevant to the audit objectives, we obtained:
  - detailed reports from the Tax Track system that identified the amount and status of federal income tax refund claims, including information about whether or not the refunds had been collected by the receivership or remained in escrow;
  - a summary listing of receiverships with tax returns that were subject to tax audit by the IRS or applicable state taxing authority;
  - a summary listing of tax refund claims that were the subject of litigation or ownership claims by third parties, such as a failed financial institution's holding company; and
  - summary information about tax refund claims and related collections that is provided to senior DRR management.

### Sampling

*Sample 1:* To perform our assessment, we used non-statistical sampling techniques to select receiverships with federal income tax refund claims for testing. The results of a non-statistical sample cannot be projected to the intended population by standard statistical methods. The sampling population was the universe of 492 receiverships established from January 1, 2007 through a judgmentally established cutoff date of December 31, 2013. The sampling frame<sup>16</sup> for the audit was a subset of the population comprising the 188 active<sup>17</sup> receiverships with federal income tax refund claims recorded in the Tax Track *Refund Analysis – Active Receiverships* report as of July 31, 2014. From the sampling frame, we selected an initial non-statistical sample of five receiverships with federal income tax refund claims in Tax Track covering a range of refund status types, including refunds that had been deposited by the FDIC, received from the IRS but remaining in escrow, denied by the IRS, or uncollected. We selected the samples to obtain dollar coverage of refunds denied and refunds collected and deposited with the FDIC or in escrow.

*Sample 2:* Based on the results we obtained from testing Sample 1, we selected a non-statistical sample of eight additional receiverships from the sampling frame for testing audit sub-objectives 1, 3 and 4. Five of the receiverships in the supplemental sample were selected based on the large dollar amount of the federal income tax refunds collected from the IRS. Three of the receiverships in the supplemental sample were

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<sup>16</sup> The sampling frame is the database, or other collection of data, containing the totality of the sampling units from which the sample will be selected, which may exclude some portion of the population.

<sup>17</sup> An active receivership is one that has not been terminated. As of July 31, 2014, Tax Track indicated that 19 of the 492 receiverships in the population had been terminated.

## Objective, Scope, and Methodology

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selected based on the large dollar amount of the federal income tax refunds denied by the IRS, as reported in Tax Track. Because the results of Sample 1 had already indicated weaknesses in internal controls related to audit sub-objective 2, we did not deem it necessary to fully test that audit sub-objective for the additional sample.

*Sample 3:* We performed other analytical review procedures that identified a non-statistical sample of 39 additional receiverships that merited some level of testing for certain tax refund claim amounts. Specifically, we:

- Sorted tax refund claims in Tax Track by refund status, and identified and reviewed tax refund claims for 10 receiverships with infrequently used<sup>18</sup> refund status codes to determine if the status code in Tax Track was correct for the tax refund claim amounts, and the amounts were recorded, as appropriate, in the NFE general ledger.
- Compared tax refund claim amounts per Tax Track to tax refunds per the *Tax Refund Status Report* dated July 2, 2014, prepared for the OIG by the FDIC Legal Division, and identified and reviewed tax refund claims for five receiverships with large dollar or percentage variances to determine whether tax refund claim amounts reflected in the Legal Division report were recorded in Tax Track.
- Compared tax refund collections per Tax Track to tax refund collections recorded in the NFE general ledger, and judgmentally reviewed tax refund collections for 24 receiverships with dollar variances of \$2 million or more, to determine if tax refund collections in Tax Track were complete, accurate, and properly recorded in the NFE general ledger.

### Testing by Audit Sub-objective

*Completeness and accuracy of management information.* We performed the following for all 13 non-statistically sampled receiverships in Samples 1 and 2:

- Reviewed available tax summary memoranda and checklists prepared by DRR at the financial institution closing for indication of unrecorded refunds.
- Reviewed the most recent *Refund Analysis* worksheet prepared by the applicable DRR Tax Accountant for indication of unrecorded refunds.
- Compared tax refund claim amounts recorded in Tax Track to relevant source documentation<sup>19</sup> to identify inaccurately recorded refund claims.

*Timeliness of responses to IRS inquiries.* We performed the following for the five non-statistically sampled receiverships in Sample 1:

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<sup>18</sup> The *Refund Status* codes reviewed were: “Carry Forward to Next Year,” “Sent for Reissue,” “Under Audit - On Hold,” and “Received by Holding Company after Closing.”

<sup>19</sup> Source documentation included such things as filed tax returns, checks and wire disbursement forms, IRS account transcripts, IRS RARs, escrow account statements, and settlement agreements, as applicable.

## Objective, Scope, and Methodology

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- Determined whether the FDIC filed IRS Form 56-F with the IRS within 10 days of the financial institution closing date, as required by IRC § 6036 and related Treasury Regulation § 301.6036-1.
- Determined whether the FDIC filed IRS Form 2848 with the IRS assigning power of attorney to DRR Tax Department personnel.
- Reviewed available DRR documentation to determine what tax audit-related information document requests had been submitted by the IRS.
- Reviewed available DRR documentation to determine whether the FDIC responded to IRS inquires, in the form of information document requests, in a timely manner.
- Reviewed IRS RARs and related documents for indication of IRS tax audit adjustments that were the result of untimely response by the FDIC to IRS information document requests. We also performed this procedure for the three receiverships in Sample 2 with large dollar federal income tax refunds denied by the IRS.

*IRS adjustments to tax refund claims are evaluated, accepted and/or appealed in accordance with relevant criteria.* We performed the following for the eight non-statistically sampled receiverships in Samples 1 and 2 where DRR personnel were substantially involved in the related IRS tax audit:

- Reviewed IRS RARs and related documents identifying the amount of, and basis for, any tax audit adjustments that reduced claimed tax refunds.
- Reviewed available DRR documentation to determine what activities DRR personnel had performed to evaluate IRS tax audit sampling and tax audit adjustments.
- Reviewed available DRR documentation indicating whether or not DRR had accepted and/or appealed IRS tax audit adjustments.
- Reviewed IRS forms documenting FDIC acceptance of IRS tax audit adjustments to verify that the person signing the form for the FDIC had the necessary delegated authority.

*Federal income tax refunds are properly recorded on the receivership books and records.* We performed the following for all 13 non-statistically sampled receiverships in Samples 1 and 2:

- Verified that tax refund amounts collected from the IRS were consistent with the amounts on the original tax return or were consistent with the IRS RAR amount, if a denial occurred.
- Verified whether the tax refund allocation between the FDIC and the holding company was in accordance with an approved court order or settlement agreement for tax refunds distributed subsequent to dispute resolution.

## Objective, Scope, and Methodology

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- Reviewed the check or wire remittance and related journal entry to ensure that tax refunds allocated to the FDIC were received and recorded to the NFE general ledger accounts for the correct receivership.
- Reviewed bank statements and escrow account reconciliations for tax refunds that were collected and placed in an escrow account pending dispute resolution.
- Verified whether potential tax refund recoveries, including refunds in escrow and refunds not yet paid by the IRS, were recorded in NFE general ledger memorandum account M1290 for the correct receivership.

We performed our work at the FDIC Dallas Regional Office, Dallas, Texas, and the FDIC Virginia Square Office, Arlington, Virginia.

### **Internal Control, Reliance on Computer-processed Information, Performance Measurement, and Compliance with Laws and Regulations**

Consistent with the stated objective, we did not assess the FDIC's overall internal control or management control structure beyond what we include in this report. We tested the completeness and accuracy of selected data recorded in the DRR's Tax Track information system as of July 31, 2014 by corroborating the data with source documents and testimonial evidence. However, we did not assess the effectiveness of information system controls. In certain instances, as discussed in this report, we noted data sufficiency issues with the Tax Track system. However, we determined that those data sufficiency issues did not materially impact our ability to address the audit objective and support our findings and conclusions.

The Government Performance and Results Act of 1993 (the Results Act), as amended, directs Executive Branch agencies to develop a customer-focused strategic plan, align agency programs and activities with concrete missions and goals, and prepare and report on annual performance plans. For this audit, we did not assess the strengths and weaknesses of the DRR annual performance plan in meeting the requirements of the Results Act because such an assessment is not part of the audit objective.

Regarding compliance with laws and regulations, we performed limited tests to determine FDIC compliance with certain aspects of IRC § 6036 and related Treasury Regulation § 301.6036-1. In addition, we assessed the risk of fraud and abuse related to our objectives in the course of evaluating audit evidence.

## Glossary of Terms

Term	Definition
<b>Assuming Institution</b>	An assuming institution is generally an active financial institution that has acquired the deposits, and in many cases, the assets, of a failed financial institution.
<b>Bankruptcy Trustee</b>	A person appointed by the Bankruptcy Court or elected by creditors to take charge of a debtor estate, collect assets, bring suit on a debtor's claims, defend actions against the debtor's estate, and otherwise administer the debtor's estate.
<b>C-Corporation</b>	A corporation that is recognized by the IRS as a separate taxpaying entity.
<b>Consolidated Group</b>	In many cases a failed financial institution is part of a holding company at the time of closing, and together they may form an "affiliated group" pursuant to IRC § 1504(a). According to IRC § 1501, an affiliated group of corporations may elect to file on a consolidated basis, rather than a separate return basis. <u>IRS Form 1120</u> is used to report income, gains, losses, deductions and credits on a combined basis less intercompany transactions to determine a group tax liability as if for a single entity. DRR guidance uses the term "consolidated group" to refer to an affiliated group.
<b>Federal Income Tax Refund Claim</b>	A taxpayer's application to the IRS to obtain repayment of federal income taxes previously paid to the United States Treasury.
<b>Fiduciary</b>	The FDIC or other federal agency authorized by law to act as a receiver or conservator of a financial institution.
<b>Funds Put to Better Use</b>	According to section 5(f)(4) of the Inspector General Act of 1978, as amended (see 5 U.S.C. Appendix), a recommendation by the Office of Inspector General that funds could be used more efficiently if management of an establishment took actions to implement and complete the recommendation, including— (A) reductions in outlays; (B) de-obligation of funds from programs or operations; (C) withdrawal of interest subsidy costs on loans or loan guarantees, insurance, or bonds; (D) costs not incurred by implementing recommended improvements related to the operations of the establishment, a contractor or grantee; (E) avoidance of unnecessary expenditures noted in pre-award reviews of contract or grant agreements; or (F) any other savings which are specifically identified.
<b>Holding Company</b>	As used in this report, a company that owns and/or controls one or more U.S. financial institutions or one that owns, or has a controlling interest in, one or more financial institutions. It is a company that qualifies under 12 U.S.C. § 1841 (also known as the Bank Holding Company Act of 1956).

## Glossary of Terms

Term	Definition
<b>IRS Account Transcript</b>	A document that contains information on the financial status of a taxpayer's tax account with the IRS, such as payments made on the account, penalty assessments, and adjustments made by the taxpayer or the IRS after the return was filed. Tax return information on the transcript is limited to items such as tax liability and estimated tax payments.
<b>IRS Form 1120</b>	An IRS form, <i>U.S. Corporation Income Tax Return</i> , used to report income, gains, losses, deductions, and credits, and to determine the income tax liability of a corporation.
<b>IRS Form 2848</b>	An IRS form, <i>Power of Attorney and Declaration of Representative</i> , used to provide the IRS with the names of individuals who are authorized to communicate with the IRS regarding tax matters for a specific receivership.
<b>IRS Form 56-F</b>	An IRS form, <i>Notice Concerning Fiduciary Relationship of Financial Institution</i> , used to notify the IRS of the FDIC's fiduciary appointment to act as a receiver or conservator of a bank or thrift. Once approved by the IRS, it allows the FDIC to file tax returns and respond to tax audits on behalf of the receivership.
<b>Joint Committee on Taxation</b>	A nonpartisan committee of the United States Congress, originally established under the Revenue Act of 1926 (see IRC § 8001). The Joint Committee operates with an experienced professional staff of Ph.D. economists, attorneys, and accountants, who assist Members of the majority and minority parties in both houses of Congress on tax legislation. Under current law, the committee is responsible for reviewing all proposed federal income tax refunds of more than \$2 million (\$5 million in the case of C-Corporations).
<b>Net Operating Loss</b>	A net operating loss occurs when a taxpayer has a taxable loss for the tax year. For income tax purposes, a net operating loss can be used to offset taxable income for a prior tax year, or a taxpayer can elect to forego the carryback and carry the net operating loss forward to offset future taxable income. The effect of the NOL carrybacks and carryforwards is to reduce taxable income and hence reduce the tax liability for the affected tax year, thereby giving rise to claims for income tax refunds.
<b>Refund Analysis</b>	A worksheet used by DRR to determine whether there are any potential refunds available should the receivership incur a net operating loss that may be carried back and applied against prior years' taxable income. It summarizes, by tax year, gross revenues, taxable income (loss), tax payments made, tax refunds received, and any remaining tax due or unrecovered refund claims. An initial analysis is prepared at a financial institution's closing, and updated as new information becomes available, such as subsequent tax filings or tax audit adjustments made by the IRS.

## Glossary of Terms

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Term	Definition
<b>Revenue Agent Report</b>	An IRS summary and explanation, by tax year, of dollar adjustments to taxable income and corresponding tax due or refund owed. The report can be documented on IRS Form 4549-A, <i>Income Tax Discrepancy Adjustments</i> , which may also be accompanied and supported by one or more IRS Form 5701, <i>Notice of Proposed Adjustment</i> , and IRS Form 886-A, <i>Explanation of Adjustments</i> .
<b>Taxing Authority</b>	Any government entity that is authorized by law to assess, levy, and collect taxes.
<b>Tax Sharing Agreement</b>	An agreement between the members of a consolidated group that may, among other things, outline the allocation of tax refunds and tax payments between group members.

## Acronyms and Abbreviations

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<b>Acronym/ Abbreviation</b>	<b>Explanation</b>
CPA	Certified Public Accountant
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
FDI	Federal Deposit Insurance
GAO	Government Accountability Office
IDR	Information Document Request
IRC	Internal Revenue Code
IRS	Internal Revenue Service
LB&I	Large Business and International
NFE	New Financial Environment
NOL	Net Operating Loss
OIG	Office of Inspector General
RAR	Revenue Agent Report
U.S.C.	United States Code
WHBAA	Worker, Homeownership, and Business Assistance Act

## Corporation Comments



**Federal Deposit Insurance Corporation**  
3701 N. Fairfax Drive, Arlington, VA 22203

Division of Resolutions and Receiverships

September 3, 2015

**TO:** Mark F. Mulholland  
Deputy Inspector General for Audits and Evaluations  
Office of Inspector General

**FROM:** Bret D. Edwards, Director /Signed/  
Division of Resolutions and Receiverships

**SUBJECT:** Management Response to Draft Audit Report Entitled, *Controls Over Receivership-Related Federal Income Tax Refunds* (Assignment No. 2014-029)

The Federal Deposit Insurance Corporation (FDIC) has completed its review of the Office of Inspector General's (OIG) revised draft audit report entitled *Controls Over Receivership-Related Federal Income Tax Refunds* (Assignment No. 2014-029) dated August 12, 2015. We appreciate the OIG's observations and recommendations to enhance the controls around the management of receivership-related federal income tax refunds.

In its report, the OIG identifies opportunities for the Division of Resolutions and Receiverships (DRR) to improve its existing controls and guidance for the following:

- Recording and maintaining the reliability of tax refund claim-related information in the Tax Track system;
- Tracking and documenting responses to IRS inquiries and more consistently recording activities performed to evaluate and accept, or appeal, tax audit adjustments; and
- Recording potential tax refund recoveries in the receivership records.

We agree with the OIG that enhancing guidance and strengthening controls would help the FDIC reduce the financial risks associated with unrecovered tax refunds and reputational risks associated with incomplete documentation of its IRS tax audit-related activities. In a continuously changing environment, opportunities for improvement will always exist. This was especially true for DRR during the current financial crisis. The 2009 legislative change (regarding Net Operating Losses) presented the FDIC with both an enormous operational challenge and a significant opportunity to recover billions of dollars in tax refunds. To date, DRR has successfully recovered over 97% of the \$4.1 billion in receivership tax refund claims, the majority of which were subject to IRS audit.

During the crisis, the most significant risk DRR tax professionals faced was complying with the statutory time constraints for claiming the refunds. As a result, management instituted significant improvements in its receivership tax-related procedures and controls that resulted in a strong control environment that mitigated the risk.

Below is a description of the FDIC's specific corrective actions for each OIG recommendation.

## Corporation Comments

**Recommendation 1:** Enhance DRR procedures to more clearly define the (1) income tax refund claim-related amounts that should be recorded in Tax Track and (2) requirements for data reliability reviews and reconciliations between Tax Track and the NFE general ledger.

**DRR Response:** DRR concurs with this recommendation.

**Corrective Action:** The Tax Department will update the Receivership Tax Manual and job aids to clearly define (1) the income tax refund claim amounts that should be recorded in Tax Track and (2) data reliability and reconciliation review requirements.

**Completion Date:** March 31, 2016

**Recommendation 2:** Enhance DRR procedures to incorporate guidelines for the tax audit response process; and the electronic and other records that should be retained to evidence the activities performed to respond to IRS inquiries, evaluate tax audit results, and document the bases for the decisions made to accept or appeal those results.

**DRR Response:** DRR concurs with this recommendation.

**Corrective Action:** The Tax Department will update the Receivership Tax Manual and job aids to: (1) more fully describe the procedures and guidelines applicable to the tax audit evaluation and response process; (2) establish documentation requirements associated with tax audit activities, including email correspondence; and (3) require that a formal case summary be prepared and approved for tax audits where the refund claims at stake equal or exceed \$2 million.

**Completion Date:** March 31, 2016

**Recommendation 3:** Enhance DRR procedures to ensure that (1) an estimate of all potential tax refund recoveries for a receivership is recorded in the receivership general ledger and (2) tax refund checks that have been sent to a taxing authority for reissuance are monitored and resolved in a timely manner.

**DRR Response:** DRR concurs with this recommendation.

**Corrective Action:** The Tax Department will update the Receivership Tax Manual to include procedures to (1) record potential tax refund recoveries in general ledger account M1290 (Tax Refunds-Possible) and (2) monitor refunds received by the holding company after a failed bank closing or when refund checks are sent back to the taxing authorities for reissuance.

**Completion Date:** March 31, 2016

**Recommendation 4:** Evaluate options for using an automated system or tool to document, track, and report tax audit-related activities, such as information document requests and responses to those requests.

**DRR Response:** DRR concurs with this recommendation.

## Corporation Comments

**Corrective Action:** The Tax Department will coordinate with DRR's Business Program Management staff to evaluate the options for implementing an automated system or tool to document, track, and report upon tax audit-related activities, including information document requests and responses to those requests (e.g., internal systems/tools could include Tax Track or SharePoint; external systems could include hosted applications or stand-alone software).

**Completion Date:** March 31, 2016

**Recommendation 5:** Develop a plan to complete follow-up efforts associated with (1) \$4,311,139 of potential federal income tax refund recoveries and (2) \$134,364 of refund checks received and then returned to a taxing authority for reissuance. [Funds put to better use of \$4,586,022, to include \$140,519 recovered during the course of the audit, and \$4,445,503 that the FDIC was in the process of collecting.]

**DRR Response:** DRR concurs with this recommendation.

**Corrective Action:** The Tax Department's plan for collecting or resolving the potential federal income tax refund recoveries, including refund checks sent to a taxing authority for reissuance, consists of the following:

Potential refund recoveries (\$4,311,139)

- *\$ redacted:* The Tax Department has completed follow-up efforts and provided supporting documentation to the OIG.
- \$1,262,408: The Tax Department will detail the actions already taken and actions planned in a memorandum that describes the approach for collecting or resolving potential federal income tax refund recoveries.

Checks returned to a taxing authority (\$134,364): The Tax Department will detail the actions already taken and actions planned in a memorandum that describes the approach for collecting or resolving refund checks received and then returned to a taxing authority for reissuance.

**Completion Date:** November 30, 2015

## Summary of the Corporation's Corrective Actions

This table presents corrective actions taken or planned by the Corporation in response to the recommendations in the report and the status of the recommendations as of the date of report issuance.

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved: <sup>a</sup> Yes or No	Open or Closed <sup>b</sup>
1	The DRR Tax Department will update the Receivership Tax Manual and job aids to clearly define (1) the income tax refund claim amounts that should be recorded in Tax Track and (2) data reliability and reconciliation review requirements.	3/31/2016	\$0	Yes	Open
2	The DRR Tax Department will update the Receivership Tax Manual and job aids to: (1) more fully describe the procedures and guidelines applicable to the tax audit evaluation and response process; (2) establish documentation requirements associated with tax audit activities, including email correspondence; and (3) require that a formal case summary be prepared and approved for tax audits where the refund claims at stake equal or exceed \$2 million.	3/31/2016	\$0	Yes	Open
3	The DRR Tax Department will update the Receivership Tax Manual to include procedures to (1) record potential tax refund recoveries in general ledger account M1290 (Tax Refunds-Possible) and (2) monitor refunds received by the holding company after a failed bank closing or when refund checks are sent back to the taxing authorities for reissuance.	3/31/2016	\$0	Yes	Open

## Summary of the Corporation's Corrective Actions

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved: <sup>a</sup> Yes or No	Open or Closed <sup>b</sup>
4	The DRR Tax Department will coordinate with DRR's Business Program Management staff to evaluate the options for implementing an automated system or tool to document, track, and report upon tax audit-related activities, including information document requests and responses to those requests.	3/31/2016	\$0	Yes	Open
5	<p>The DRR Tax Department collected \$140,519 during the course of our audit. In addition, DRR completed follow-up efforts on <i>\$redacted</i> of potential tax refunds and provided documentation supporting that this amount is not collectable.</p> <p>The DRR Tax Department will develop memorandums that describe the approach for collecting or resolving \$1,262,408 of potential tax refunds and \$134,364 of tax refund checks received and then returned to a taxing authority for reissuance.</p>	11/30/2015	\$4,586,022 (of which \$1,396,772 is still under review)	Yes	Open

- <sup>a</sup> Resolved – (1) Management concurs with the recommendation, and the planned, ongoing, and completed corrective action is consistent with the recommendation.  
(2) Management does not concur with the recommendation, but alternative action meets the intent of the recommendation.  
(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.

<sup>b</sup> Recommendations will be closed when (a) Corporate Management Control notifies the OIG that corrective actions are complete or (b) in the case of recommendations that the OIG determines to be particularly significant, when the OIG confirms that corrective actions have been completed and are responsive.