Treasury Inspector General for Tax Administration
Office of Audit

MANY INVESTMENT THEFT LOSS DEDUCTIONS APPEAR TO BE ERRONEOUS

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Highlights

Highlights of Report Number: 2011-40-124 to the Internal Revenue Service Commissioners for the Small Business/Self-Employed Division and the Wage and Investment Division.

IMPACT ON TAXPAYERS

Federal law, along with associated regulations, procedures, and rulings, provides taxpayers with tax relief for investment theft losses. The Internal Revenue Service (IRS) estimates that more than 19,200 taxpayers filed Tax Year 2008 tax returns claiming a combined total of more than $8 billion in property income casualty and theft deductions. Our review identified that taxpayers may be erroneously claiming investment theft loss deductions. Revenue losses associated with potentially erroneous deductions could be substantial.

WHY TIGTA DID THE AUDIT

The number of investment theft loss victims as a result of Ponzi schemes increased significantly in Tax Years 2008 and 2009. With the potentially large number of victims filing tax returns claiming these losses, IRS officials issued guidance to minimize the IRS's administrative burden and the burden on the victims of Ponzi schemes. The objective of this review was to assess the IRS's efforts to ensure the validity of investment theft loss deductions.

WHAT TIGTA FOUND

IRS processes are not identifying all taxpayers claiming investment theft losses and taxpayers erroneously claiming investment theft loss deductions. Although information is available on the tax returns claiming investment theft losses, the information is not always being used to ensure that taxpayers are eligible for the investment theft loss deduction. As a result, the IRS is not identifying the total number of taxpayers claiming these losses.

In addition, Casualties and Thefts (Form 4684) needs to be redesigned to include additional information when taxpayers claim investment theft loss deductions. The additional information could be used to ensure compliance.

Based on our review of a statistically valid sample of 140 electronically filed Tax Year 2008 tax returns on which taxpayers reported an investment theft deduction, TIGTA estimates that 1,788 (82 percent) of 2,177 taxpayers may have erroneously claimed deductions totaling more than $697 million, resulting in revenue losses totaling approximately $41 million. The potential revenue loss estimate is conservative in that it only represents electronically filed tax returns for one year.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS improve its process to identify taxpayers claiming investment theft losses on tax returns, revise the Form 4684 to include additional information on the investment theft loss deduction, establish a Compliance Initiative Project to measure noncompliance for investment theft loss claims, and review applicable flow-through return information to make process changes as practicable.

The IRS agreed with our recommendations and plans to take corrective actions.

READ THE FULL REPORT

To view the report, including the scope, methodology, and full IRS response, go to:

http://www.treas.gov/tigta/auditreports/2011reports/201140124fr.pdf.

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