TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Casualty and Theft Loss Deductions Continue to Be Erroneously Processed Without a Valid Federal Emergency Management Agency Number

July 14, 2021

Report Number: 2021-40-045

TIGTACommunications@tigta.treas.gov | www.treasury.gov/tigta

HIGHLIGHTS: Casualty and Theft Loss Deductions Continue to Be Erroneously Processed Without a Valid Federal Emergency Management Agency Number

Final Audit Report issued on July 14, 2021 | **Report Number 2021-40-045**

Why TIGTA Did This Audit

This audit was initiated to follow up on previous TIGTA recommendations related to IRS processing of tax returns claiming a deduction for a casualty and theft loss.

The Tax Cuts and Jobs Act of 2017 limited the personal casualty and theft loss deduction to only those claims associated with Federally declared disasters for Tax Years 2018 through 2025.

Impact on Taxpayers

Casualty and theft loss deductions are included on Form 4684, *Casualties and Thefts*, and reported as a deduction on Form 1040, *U.S. Individual Income Tax Return*, from the Schedule A, *Itemized Deductions*. Taxpayers are instructed to enter the Federal Emergency Management Agency (FEMA) number that qualifies as a Federally declared disaster area on their Form 4684.

In January 2020, TIGTA reported that IRS processes did not ensure that taxpayers provided the required FEMA number on 7,761 tax returns with disaster-related casualty and theft loss deductions totaling $267.9 million.

What TIGTA Found

As a result of TIGTA's prior report, the IRS agreed to evaluate addressing tax returns that do not contain the required FEMA number in the Error Resolution function. However, because of the increased workload due to the Coronavirus Disease 2019, this has not yet been accomplished. As such, potentially erroneous casualty and theft loss deductions are still not being addressed during processing.

TIGTA's review of Tax Year 2019 tax returns processed as of September 3, 2020, identified 34,699 tax returns that claimed a casualty and theft loss deduction. TIGTA found that 12,075 (35 percent) of the 34,699 either had a FEMA number that did not match the FEMA number on the taxpayer's tax account, had an invalid FEMA number, or were missing the FEMA number. The deductions claimed on these returns totaled more than $309 million. TIGTA estimates these individuals underpaid approximately $41.3 million in income tax.

In addition, IRS management's analysis of the 7,761 tax returns TIGTA identified in its previous review determined that 33 tax returns were addressed through the unallowable treatment stream, and only 183 tax returns would meet their Campus Exam filter selections and dollar tolerance. The fact that only 2.4 percent of the identified cases will potentially be examined further supports TIGTA's prior recommendation that these tax returns should be identified for review during processing rather than being examined after processing.

What TIGTA Recommended

TIGTA made three recommendations to improve the processing of casualty and theft loss deduction claims. The IRS should develop processes and procedures to identify tax returns at the time returns are filed for which the FEMA number is not provided or is not valid and establish processes to identify returns for post compliance review when the FEMA number on the tax return does not match the number on the taxpayer's tax account. The IRS should also review the 12,075 tax returns TIGTA identified.

IRS management agreed or partially agreed with two recommendations. IRS management revised the Form 4684, *Casualties and Thefts*, so the request to prompt taxpayers for the declarations labeled "DR" or "EM", and will evaluate the effectiveness of the change after the 2021 Filing Season. IRS management also agreed to review the 12,075 returns TIGTA identified.

IRS management did not agree to establish a process to consider deduction claims for post compliance review when the FEMA number on the tax return and the number in the taxpayer's tax account do not match. IRS management stated that they already have a process in place to identify anyone who is not in a Federally declared disaster area regardless of whether the return has a different FEMA number, has an invalid FEMA number, or is missing a FEMA number.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

July 14, 2021

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Casualty and Theft Loss Deductions Continue to Be Erroneously Processed Without a Valid Federal Emergency Management Agency Number (Audit # 202140024)

This report presents the results of our review to follow up on previous Treasury Inspector General for Tax Administration recommendations related to Internal Revenue Service processing of tax returns claiming a deduction for a casualty and theft loss. This review is part of our Fiscal Year 2021 audit coverage and addresses the major management and performance challenge of *Implementing Tax Law Changes.*

Management's complete response to the draft report is included as Appendix III.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services).

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Background

When the President declares a Federal disaster or emergency, immediate notification is made to the Governor of the affected State or U.S. Territory, appropriate members of Congress, and Federal departments and agencies. The Internal Revenue Service (IRS) Disaster Assistance and Emergency Relief Program Office prepares and distributes an internal Disaster Relief Memorandum to the IRS that summarizes the tax relief to be provided. Individuals and businesses in eligible counties are identified by zip code. For those individuals and businesses affected, the IRS adds the specific Federal Emergency Management Agency (FEMA) disaster declaration number (hereafter referred to as a FEMA number) that identifies the Federally declared disaster to the tax account. Taxpayers who live outside the identified zip codes and are affected by a Federally declared disaster can self-identify by calling the IRS's disaster toll-free telephone line. The IRS will automatically grant tax relief and manually input the FEMA number on the taxpayer's account.

Individuals who experience a casualty or theft loss may be eligible to claim a deduction on their annual tax return. The Tax Cuts and Jobs Act of 2017[1] limited the personal casualty and theft loss deduction ***to only those claims*** associated with Federally declared disasters for Tax Years 2018 through 2025. Casualty and theft loss deductions are included on Form 4684, *Casualties and Thefts,* and reported as a deduction on Form 1040, *U.S. Individual Income Tax Return,* from the Schedule A, *Itemized Deductions*. Taxpayers are instructed to enter the FEMA number that qualifies as a Federally declared disaster area on their Form 4684.

In July 2018, we reported that the IRS timely and accurately placed FEMA numbers on taxpayer accounts.[2] We also reported that the IRS provides a process by which affected taxpayers located outside of a covered disaster area can self-identify for disaster relief. However, in January 2020, we reported that IRS processes did not ensure that individuals claiming a disaster-related casualty loss deduction provide a valid FEMA number as required.[3] Our analysis of 52,011 tax returns processed as of May 2, 2019, that claimed casualty losses totaling more than $1.2 billion identified 7,761 (15 percent) tax returns for which the filer did not include the required FEMA number. These individuals reported deductions totaling $267.9 million. Figure 1 summarizes the recommendations the Treasury Inspector General for Tax Administration (TIGTA) made and the IRS's response to these recommendations.

[1] Pub. L. No. 115-97, 131 Stat. 2054.

[2] Treasury Inspector General for Tax Administration (TIGTA), Report No. 2018-40-049, *Actions Were Taken to Timely Provide Disaster Relief Tax Assistance to Victims of Hurricanes Harvey, Irma, and Maria* pp. 5-8 (July 2018).

[3] TIGTA, Report No. 2020-44-007, *Results of the 2019 Filing Season* p. 18 (Jan. 2020).

Figure 1: Summary of Prior TIGTA Recommendations Related to Casualty and Theft Losses

Recommendation	Description
Create a business rule to reject tax returns when a casualty and theft loss deduction is included on Schedule A and Form 4684 does not include the required FEMA disaster declaration number.	The IRS partially agreed with this recommendation to the extent that it will reduce the volume of returns processed with missing FEMA disaster declaration numbers. IRS management does not think the rejection of these returns is the appropriate treatment. The absence of a FEMA disaster declaration number on a return claiming a casualty loss does not make an otherwise eligible loss ineligible. The determination of eligibility for the deduction is a question that can be answered only through an examination, a process that must be conducted under deficiency procedures. With input from its compliance functions, IRS management plans to develop processes to identify returns missing the disaster declaration numbers and route them to the Error Resolution function for treatment.
Review the 7,761 tax returns that claimed the casualty and theft loss deduction but did not provide a sufficient FEMA disaster declaration number to determine if the taxpayers are entitled to the deductions claimed.	The IRS agreed with this recommendation. In July 2018, IRS management implemented post-processing business rules to identify casualty and theft loss deductions that did not provide a valid disaster declaration number. Management plans to continue using its existing post-processing business rules to identify returns that do not provide a sufficient disaster declaration number.

Source: TIGTA, Report No. 2020-44-007, Results of the 2019 Filing Season pp. 21-22 (Jan. 2020).

Results of Review

We continue to find that IRS processes and procedures do not ensure that taxpayers claiming a deduction for a disaster-related casualty and theft loss provide a valid FEMA number as required. Our review of Tax Year 2019 tax returns processed as of September 3, 2020, identified 12,075 returns that claimed a casualty and theft loss deduction and had a potentially invalid FEMA number.

While the IRS agreed to evaluate addressing tax returns that do not contain the required FEMA number in the Error Resolution function, because of the increased workload due to the Coronavirus Disease 2019, this has not yet been accomplished. As such, potentially erroneous casualty and theft deductions are still not being addressed during processing.

In addition, IRS management analyzed the 7,761 tax returns we identified in our previous review and determined that 33 tax returns were addressed through the unallowable treatment stream,[4] and only 183 tax returns would meet their Campus Exam filter selections and dollar tolerance. The IRS indicated that the 183 tax returns will be added to inventory for potential selection for review. However, the fact that only 2.4 percent of the identified cases will potentially be examined further supports our recommendation that these tax returns should be identified for review during processing rather than being examined after processing.

Processes Still Do Not Ensure That Valid Federal Emergency Management Agency Numbers Are Provided in Support of Casualty and Theft Loss Claims

Our review of Tax Year 2019 tax returns processed as of September 3, 2020, identified 34,699 tax returns that claimed a casualty and theft loss deduction on Schedule A.[5] We found that 12,075 (35 percent) of the 34,699 returns either had a FEMA number that did not match the FEMA number on the taxpayer's tax account, had an invalid FEMA number, or were missing the FEMA number. The deductions claimed on these returns totaled more than $309 million. We estimate these individuals underpaid approximately $41.3 million in income tax. These include:

- 9,455 returns with deductions that totaled more than $228.2 million for which the FEMA number provided on the tax return does not match the FEMA number shown in the taxpayer's tax account.[6] The tax effect for these deductions is more than $32.1 million. The IRS took no actions to verify the legitimacy of these claims at the time the returns were filed. [redacted].
- 1,930 returns with deductions that totaled more than $52.1 million for which the taxpayer did not provide a FEMA number. The tax effect for these deductions is more than $6.2 million.
- 690 returns with deductions that totaled more than $29.2 million for which the taxpayer provided an "obviously invalid" FEMA number. The tax effect for these deductions is more than $2.9 million. For our review, an obviously invalid FEMA number is a number that does not contain a "DR" or "EM,"[7] consists of the same digits, *e.g.*, 1111, 2222, 3333, or is outside the range of FEMA numbers applicable for that time frame.

We provided these cases to the IRS on November 16, 2020. The IRS responded on December 22, 2020, stating it does not have [redacted]. IRS management also indicated that, as of January 1, 2020, they were [redacted]

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[4] The Unallowable program is a prerefund program that identifies items on a return for potential audit during return processing. Returns claiming casualty or theft losses meeting specific criteria were assigned a code and sent to the Examination function for review.

[5] These taxpayers filed Form 4684 and claimed a casualty or theft loss on Schedule A.

[6] The FEMA numbers provided on the 9,455 tax returns were numbers issued by FEMA, but they did not match the FEMA number recorded in the taxpayer's tax account.

[7] FEMA numbers for presidentially declared disasters will include either a DR or an EM. A DR designates disaster recovery or disaster response and the EM designates emergency management.

[redacted]. IRS management said this decision was based on the potential for this issue to be reviewed post processing.

The Commissioner, Wage and Investment Division, should:

Recommendation 1: As previously reported, develop processes and procedures to identify tax returns at the time returns are filed for which there is a casualty and theft loss deduction claimed on Schedule A and the FEMA number is not provided or is not valid to send to the Error Resolution function to be addressed.

> **Management's Response:** The IRS partially agreed with this recommendation. IRS management stated that the absence of the FEMA number on Form 4684 is not a condition the IRS could use to summarily determine whether the claim is unallowable. Such a determination must be made under deficiency procedures, which is beyond the scope of the Error Resolution function. However, Form 4684 was modified for Tax Year 2020 so that the request for the FEMA numbers are more explicit in that it prompts specifically for the declarations labeled "DR" or "EM." IRS management plans to evaluate the effectiveness of this change to Form 4684 at the conclusion of the 2021 Filing Season to determine if the change materially decreased the volume of losses claimed without the declaration numbers. If the change did not have a material impact, management will discuss with industry partners the possibility of incorporating into their tax preparation software products prompts or reminders to taxpayers claiming casualty losses of the need to provide the FEMA numbers.
>
> > **Office of Audit Comment:** Although the actions taken may reduce reporting errors, these actions will not identify and address casualty deduction claims with a missing or invalid FEMA number at the time the return is filed. In addition, contrary to IRS management's assertion, the IRS can and does address tax returns with similar errors (*i.e.*, errors that require the use of deficiency procedures) in its Error Resolution function.[8] Finally, in December 2020, IRS management agreed to develop processes and procedures that provide taxpayers with the opportunity to self-correct errors, such as a missing FEMA number, on accepted electronically filed returns that are suspended from processing for manual error resolution. No such procedures have been developed to date.

Recommendation 2: Establish processes to identify tax returns for consideration for post compliance review for which the FEMA number provided on the tax return is different from the FEMA number in the taxpayer's tax account.

> **Management's Response:** The IRS disagreed with this recommendation. IRS management stated that they already consider the FEMA number on the taxpayer's account, and their current rules identify anyone who is not in a Federally declared disaster area regardless of whether the return has a different FEMA number, has an invalid FEMA number, or is missing a FEMA number. Therefore, no material benefit would be achieved in performing a direct match of the FEMA number on the tax return to the FEMA number on the taxpayer's account. Management also believes the match

[8] Examples include alimony deduction claims with a missing alimony recipient Taxpayer Identification Number and returns that report supplemental profit or loss with no Schedule E, *Supplement Income and Loss*, attached.

recommended by TIGTA could unnecessarily flag compliant taxpayers for review who had input or transcription errors associated with the FEMA number. The proposed matching would waste scarce resources and unduly burden taxpayers who are already dealing with the aftermath of a disaster. In addition, the Small Business/Self-Employed Division currently has processes in place to identify [redacted]. These systemic rules were implemented in response to the Tax Cuts and Jobs Act, which impacted returns reporting casualty and theft losses beginning with Tax Year 2018.

Office of Audit Comment: The examination selection criteria provided during our review identifies claims for which [redacted].

Recommendation 3: Review the 12,075 tax returns we identified that claimed a casualty and theft loss deduction on Schedule A but did not provide a sufficient FEMA number to determine if the taxpayers are entitled to the deductions claimed.

Management's Response: The IRS agreed with this recommendation. IRS management analyzed the tax returns identified and found a significant number that did not meet its selection tolerance. IRS management applied their existing filtering rule to the remaining cases to remove cases that likely qualify for the casualty loss deduction. As a result, management determined that nearly all the remaining cases would be eliminated from further compliance action and [redacted] of the cases identified by TIGTA, are above IRS selection tolerance. Under current IRS procedures, these cases are available for selection in accordance with existing prioritization and resources.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to follow up on previous TIGTA recommendations related to IRS processing of tax returns claiming a deduction for a casualty and theft loss. To accomplish our objective, we:

- Evaluated actions the IRS took to address prior recommendations related to the Tax Cuts and Jobs Act provision to limit personal casualty and theft loss.
- Determined if the FEMA number on the casualty and theft loss form does not match the FEMA number on the entity of the tax account.
- Determined if the FEMA number on the casualty and theft loss form is not valid, *e.g.*, improper format, incorrect number of digits.
- Determined if the FEMA number is not present on the casualty and theft loss form.
- Quantified the number and the amount of claims for the exceptions we identified.

Performance of This Review

This review was performed with information obtained from the Wage and Investment Division headquarters in Atlanta, Georgia; the Wage and Investment Division Submission Processing function offices in Cincinnati, Ohio; and the Information Technology organization in Lanham, Maryland, during the period November 2019 through December 2020. We conducted this performance audit 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.

Major contributors to the report were Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services); Deann L. Baiza, Director; Sharla J. Robinson, Audit Manager; Sandra L. Hinton, Lead Auditor; Tracy M. Hernandez, Senior Auditor; Donald Meyer, Information Technology Specialist; and Laura Haws, Information Technology Specialist (Applied Research and Technology).

Validity and Reliability of Data From Computer-Based Systems

We used data extracts from the Individual Master File and the Individual Returns Transaction File for Processing Year 2020. Prior to audit testing, we reviewed the data extracts to ensure that the extracted data were valid and reliable and contained the information needed for audit testing. We used judgmental samples to verify that the data contained in the extracts matched the information found in the Employee User Portal and Integrated Data Retrieval System databases. Audit tests were performed with the extracted data to identify Tax Year 2019 tax returns with noncompliance of casualty and theft reporting requirements. We determined that the data were sufficiently reliable for purposes of this report.

Internal Controls Methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: the process for planning, organizing, directing, and controlling program operations for the 2020 Filing Season. We evaluated these controls by monitoring IRS weekly production meetings, reviewing IRS procedures, and reviewing IRS reports.

Appendix II

Outcome Measure

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; approximately $41.3 million in additional income tax assessed for 11,902 Tax Year 2019 tax returns due to noncompliance with casualty and theft deduction reporting requirements; approximately $206 million over five years[1] (see Recommendations 1 through 3).

Methodology Used to Measure the Reported Benefit:

We identified taxpayers who had a Tax Year 2019 tax return with a Form 4684 that claimed a casualty loss on Schedule A. Generally, taxpayers can take a casualty and theft deduction related to their home, household items, and vehicles on their income tax return if the loss is caused by a Federally declared disaster. The casualty and theft deduction flows through to Schedule A, increasing the itemized deductions on Form 1040.

Using the Processing Year 2020 Individual Returns Transaction File, we identified 36,216 Forms 4684 that claimed a deduction for casualty and theft loss for Tax Year 2019. We limited our population to 34,699 tax returns that claimed a casualty loss on Form 4684 and claimed that loss on Schedule A. We further limited our population to 12,075 returns with a Form 4684 that claimed a loss without a FEMA number listed on the form or forms for which the FEMA number was either invalid or did not match the information in the taxpayer's account.

We created three separate populations and identified the following:

- 9,455 returns with a Form 4684 that claimed deductions totaling $228,295,498 for which the form listed a FEMA number that did not match the taxpayer's account.
- 1,930 returns with a Form 4684 that claimed deductions totaling $52,135,672 for which the FEMA number was not included on the form.
- 690 returns with a Form 4684 that claimed deductions totaling $29,267,796 for which the FEMA number on the form was "obviously invalid," *e.g.*, does not contain "DR" or "EM" or contains consistent or consecutive numbers.

In order to calculate the difference in tax if the deduction would have been disallowed, we used a tax simulator tool that enabled us to recalculate a tax return based on adjustments to specific line items on a tax return. For example, for tax returns on which a casualty loss is being claimed, we reduced the amount of the itemized deduction on the Schedule A by the casualty loss amount. If the itemized deduction amount was less than the standard deduction amount, then

[1] The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.

the standard deduction would be applied. This allowed us to recalculate the tax returns to show the effect of removing the casualty loss.

The tax simulator tool provides a more accurate tax effect estimate for outcome measure purposes because it considers each tax return's specific tax situation, including the tax rate and credits and deductions claimed. The results more accurately represent the tax effect rather than applying an average or estimated tax rate to the whole return population.

The tax simulator tool works in two iterations. It first attempts to recreate the original returns as posted on the IRS's Individual Returns Transaction File and determines whether its programming can accurately recreate the returns. Doing this confirms whether the tax simulator program would come up with the same tax return figures as the IRS did before considering any audit adjustments (confirms whether the tax simulator program is a good fit for the return). Returns that it could not accurately recreate within a certain dollar tolerance are set aside and not adjusted (the tax simulator determined it would not have come up with the original return as posted and would therefore not accurately calculate any audit adjustments). This first iteration reduced our population of exceptions from 12,075 returns to 11,902 returns.

The second iteration applies audit adjustments and calculates tax effect. Audit adjustments overwrite the original amounts on the returns and can be applied to certain line items on the Form 1040. Once the audit adjustments are applied, the tax simulator tool then uses the new amounts to recalculate the return. The tax simulator tool updates several summary, deduction, and credit line items on the return. The tax simulator tool does have limitations. For example, the tax simulator tool:

- Does not recalculate every line item on the tax return.
- Cannot account for rounding methods used by the taxpayer or IRS adjustments made by the IRS.
- Cannot account for data from underlying tax worksheets not transcribed by the IRS.

To be conservative in our outcome measure, we considered only tax returns recalculated using the tax simulator tool. This resulted in the following populations:

- 9,339 returns that claimed a casualty deduction for which the FEMA number on the return was issued by FEMA but does not match the FEMA number shown on the taxpayer's account. The total tax effect for the returns is $32,137,871.
- 1,884 returns that claimed a deduction for which the taxpayer did not list a FEMA number on their form. The total tax effect for the returns is $6,251,387.
- 679 returns that claimed a deduction for which the taxpayer provided an "obviously invalid" FEMA number. The total tax effect for the returns is $2,964,901.

For the 11,902 (9,339 + 1,884 + 679) tax returns, we compared the Form 1040, Line 12a, tax amount of $157,518,889 to the recalculated amount of $198,873,048 from the tax simulator tool, resulting in a difference of $41,354,159 ($32,137,871 + $6,251,387 + $2,964,901). We forecast that taxpayers could be assessed $206,770,795 in additional income tax over the next five years ($41,354,159 x 5) due to noncompliance with casualty and theft loss reporting requirements.[2]

[2] The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.

Management's Response: IRS management disagreed with the outcome measure, stating that their review indicates that many of the identified deductions are likely valid. Management also stated that, for the remaining cases, TIGTA failed to consider the opportunity cost of diverting resources from more productive work and [redacted].

Office of Audit Comment: Our outcome measure represents the potential revenue the IRS can protect by improving its processes and procedures. The actual amount of revenue the IRS will protect is dependent on each taxpayer's individual circumstances and the priority the IRS places on these erroneous claims. In addition, IRS management concluded that the 12,075 returns we identified are likely valid because [redacted] of the returns are under the selection tolerance or did not meet the existing filtering criteria. However, as discussed in this report, the IRS's current criteria [redacted]. Of the 12,075 returns we identified, [redacted].

Appendix III

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

June 14, 2021

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: De Lon Harris
Commissioner, Small Business/Self-Employed Division, Examination

SUBJECT: Draft Audit Report – Casualty and Theft Loss Deductions Continue to Be Erroneously Processed Without a Valid Federal Emergency Management Agency Number (Audit # 202140024)

Thank you for the opportunity to review and comment on the subject draft audit report. Generally, taxpayers may deduct casualty and theft losses, if the loss is attributable to a federally declared disaster. We appreciate that TIGTA continues to acknowledge that we timely and accurately placed disaster codes on taxpayer accounts and provide a process by which affected taxpayers located outside of a covered disaster area can self-identify for disaster relief.

The Federal Emergency Management Agency (FEMA) assigns a number to each federally declared disaster area, and the IRS instructs taxpayers to provide the FEMA number on Form 4684, *Casualties and Thefts*. However, the lack of a valid FEMA number on the Form 4684 submitted with a taxpayer's return deducting a casualty loss does not invalidate the return or the casualty loss deduction. For this reason, TIGTA's statements throughout its report that a FEMA number is "required" for a taxpayer to claim a casualty loss are simply incorrect, and TIGTA's claim in the title that the IRS "erroneously processed" these returns is incorrect.

Although the determination of eligibility for the deduction is a question that can only be answered through an examination, TIGTA notes that we had agreed, in response to an earlier report, to develop a process to identify returns missing the disaster declaration numbers and route them to the Error Resolution function for treatment. Significant resource constraints have left us unable to implement that recommendation to date. However, Form 4684, *Casualties and Thefts*, was modified for tax year 2020 so that the request for the FEMA federally declared disaster numbers is more explicit in that it prompts specifically for the "DR" or "EM" labeled declarations.

In addition to the steps taken in processing the returns, our post-processing Discretionary Exam Business Rules (DEBR) identify casualty loss claims from taxpayers [redacted], remove claims that have additional factors indicating compliance, and address the remaining returns as resources allow.

Additionally, we disagree with the outcome measure. Our review indicates that many of the identified deductions are likely valid. TIGTA also fails to consider that the potentially invalid deductions [redacted], and the opportunity costs of diverting resources from more productive work.

Attached is our detailed response to your recommendations. If you have any questions, please contact me or Scott Irick, Director, Examination Operations, SB/SE Division.

Attachment

Attachment

Recommendation 1: The Commissioner, Wage and Investment Division, should, as previously reported, develop processes and procedures to identify tax returns at the time returns are filed in which there is a casualty and theft loss deduction claimed on Schedule A, and the FEMA number is not provided or is not valid to send to the Error Resolution function to be addressed.

Planned Corrective Action:
The absence of the Federal Emergency Management Agency (FEMA) federally declared disaster declaration number on Form 4684 is not a condition under which the IRS can summarily determine that the claim is unallowable. Such a determination must be made under deficiency procedures, which is beyond the scope of the Error Resolution function. It should be noted that Form 4684, *Casualties and Thefts*, was modified for tax year 2020 so that the request for the FEMA federally declared disaster numbers is more explicit in that it prompts specifically for the “DR” or “EM” labeled declarations. We will evaluate the effectiveness of this change to Form 4684 at the conclusion of the 2021 filing season to determine if the change materially decreased the volume of losses claimed without the declaration numbers. If the change did not have a material impact, we will discuss with industry partners the possibility of incorporating into their tax preparation software products prompts or reminders to taxpayers claiming casualty losses of the need to provide the federally declared disaster numbers.

Implementation Date:
January 15, 2022

Responsible Official:
Director, e-File Services, Submission Processing, Customer Account Services, Wage and Investment Division

Corrective Action Monitoring Plan:
We will monitor this corrective action as part of our internal management control system.

Recommendation 2: The Commissioner, Wage and Investment Division, should establish processes to identify tax returns for consideration for post compliance review in which the FEMA number provided on the tax return is different from the FEMA number in the taxpayer’s tax account.

Planned Corrective Action:
We already consider the FEMA number on the taxpayer’s account, and our current rules identify anyone who is not in a Federal Disaster area regardless of whether the return has a different FEMA number, has an invalid FEMA number, or is missing a FEMA number. Therefore, no material benefit would be achieved in performing a direct match

of the FEMA number on the tax return to the FEMA number on the taxpayer's account. In addition, the match recommended by TIGTA could unnecessarily flag compliant taxpayers for review who had input or transcription errors associated with the FEMA number. The proposed matching would waste scarce resources and unduly burden taxpayers who are already dealing with the aftermath of a disaster. In addition, SB/SE currently has processes in place to identify taxpayers [redacted]. These systemic rules were implemented in response to the Tax Cuts and Jobs Act, which impacted returns reporting casualty and theft losses beginning with 2018 tax years.

Implementation Date:
N/A

Responsible Official:
N/A

Corrective Action Monitoring Plan:
N/A

Recommendation 3:
The Commissioner, Wage and Investment Division, should review the 12,075 tax returns we identified that claimed a casualty and theft loss deduction on Schedule A but did not provide a sufficient FEMA number to determine if the taxpayers are entitled to the deductions claimed.

Planned Corrective Action:
We analyzed the tax returns identified and found a significant number would not meet our selection tolerance. We applied our existing filtering rule to the remaining cases to remove cases that likely qualify for the casualty loss deduction. As a result, we determined that nearly all the remaining cases would be eliminated from further compliance action and that [redacted] of the cases identified by TIGTA are above our selection tolerance. Under our current procedures, these cases are available for selection in accordance with our existing prioritization and resources.

Implementation Date:
N/A

Responsible Official:
N/A

Corrective Action Monitoring Plan:
N/A

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Outcome Measure 1:
Revenue Protection – Potential; approximately $41.3 million in additional income tax assessed for 11,902 Tax Year 2019 tax returns due to noncompliance reporting for casualty and theft deduction requirements; approximately $206 million over five years (see Recommendations 1 through 3).

IRS Response:
We disagree with this outcome measure. As we noted in response to Recommendation 3, [redacted] of the identified cases is below our selection tolerance. For the remaining cases, TIGTA fails to consider the opportunity cost of diverting resources from more productive work and [redacted].

Appendix IV

Glossary of Terms

Term	Definition
Employee User Portal	The internal IRS portal that allows employees to access IRS data and systems, such as tax administration processing systems and financial information systems, in a secure, authenticated session.
Filing Season	The period from January through mid-April when most individual income tax returns are filed.
Individual Master File	The IRS database that maintains transactions or records of individual tax accounts.
Individual Returns Transaction File	A database the IRS maintains that contains information on the individual tax returns it receives.
Integrated Data Retrieval System	IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.
Processing Year	The calendar year in which the tax return or document is processed by the IRS.
Tax Year	A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

Appendix V

Abbreviations

FEMA	Federal Emergency Management Agency
IRS	Internal Revenue Service
TIGTA	Treasury Inspector General for Tax Administration

To report fraud, waste, or abuse, call our toll-free hotline at:

(800) 366-4484

By Web:

www.treasury.gov/tigta/

Or Write:

Treasury Inspector General for Tax Administration

P.O. Box 589

Ben Franklin Station

Washington, D.C. 20044-0589

Information you provide is confidential, and you may remain anonymous.