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**TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION**



***Processes to Address Erroneous  
Adoption Credits Result in Increased  
Taxpayer Burden and Credits  
Allowed to Nonqualifying Individuals***

June 13, 2012

Reference Number: 2012-40-065

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

***Redaction Legend: 2(f) = Risk of Circumvention of Agency Regulation or Statute***

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## HIGHLIGHTS

### PROCESSES TO ADDRESS ERRONEOUS ADOPTION CREDITS RESULT IN INCREASED TAXPAYER BURDEN AND CREDITS ALLOWED TO NONQUALIFYING INDIVIDUALS

## Highlights

Final Report issued on June 13, 2012

Highlights of Reference Number: 2012-40-065 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

### IMPACT ON TAXPAYERS

One of the challenges the IRS addresses each year in processing tax returns is the implementation of new tax law changes. The passage of the Patient Protection and Affordable Care Act made the Adoption Credit refundable for Tax Years 2010 and 2011. As of December 23, 2011, the IRS had received 101,627 Adoption Credit claims totaling more than \$1.2 billion for Tax Year 2010. Although the Adoption Credit provides benefits to many individuals who qualify, the unintended consequence of refundable credits is that they are often the target of unscrupulous individuals who file erroneous claims for these credits.

### WHY TIGTA DID THE AUDIT

This audit was initiated because, for Tax Years 2010 and 2011, the Adoption Credit became a refundable credit and the maximum credit amount was increased to \$13,170 per adopted child for Tax Year 2010. The overall objective of this review was to assess the IRS's efforts to ensure the accuracy of Adoption Credit claims for tax returns filed from January 1 through August 6, 2011.

### WHAT TIGTA FOUND

The law did not provide and the IRS did not seek math error authority for Adoption Credit claims that did not include sufficient documentation. As a result, 43,295 (42.6 percent) of the 101,627 total Adoption Credit claims were referred to the IRS's Examination function because of incomplete or missing

documentation. Math error authority would have allowed the IRS to spend approximately \$1.9 million for other high-priority programs in the Examination function.

Our review also found that, as of August 6, 2011, the IRS processed 94,092 tax returns with an Adoption Credit claim and found that 4,258 (4.5 percent) taxpayers received almost \$49.3 million in Adoption Credits without sufficient supporting documentation. Of these 4,258 taxpayers, TIGTA estimated that 953 tax returns claiming Adoption Credits totaling more than \$11 million were erroneous.

In addition, TIGTA found that 333 taxpayers who had valid Adoption Credit claims totaling \$2 million had their Credits incorrectly suspended and their tax returns were referred to the Examination function. These taxpayers had previously provided documentation when they applied for a Taxpayer Identification Number for a pending U.S. adoption.

### WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS develop a process to prevent taxpayers from receiving the Adoption Credit when a foreign adoption is in process and to ensure that taxpayers identified as erroneously claiming the Adoption Credit are reviewed in the Examination function. The IRS should also ensure that computer programming accurately excludes tax returns that list Adoption Taxpayer Identification Numbers on Form 8839, *Qualified Adoption Expenses*, and indicate the adoption is in process so these taxpayers do not have their refunds erroneously suspended and delayed.

IRS management agreed and implemented corrective actions for all the recommendations. The corrective actions included changing processing procedures, updating instructions, and training employees to ensure erroneous adoption benefits are identified when a foreign adoption is in process. In addition, programming changes were implemented for the 2012 Filing Season to prevent refund delays when an Adoption Taxpayer Identification Number is used. Returns TIGTA identified for taxpayers who potentially received erroneous adoption credits were selected for examination, when warranted.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

**DEPARTMENT OF THE TREASURY**  
**WASHINGTON, D.C. 20220**

June 13, 2012

**MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION**

A handwritten signature in black ink, appearing to read "Michael E. McKenney".

**FROM:** Michael E. McKenney  
Acting Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – Processes to Address Erroneous Adoption Credits  
Result in Increased Taxpayer Burden and Credits Allowed to  
Nonqualifying Individuals (Audit # 201140033)

This report presents the results of our review to assess the Internal Revenue Service's efforts to ensure the accuracy of Adoption Credit claims for tax returns filed from January 1 through August 6, 2011. This review was included in our Fiscal Year 2011 Annual Audit Plan and addresses the major management challenges of Implementing Health Care and Other Tax Law Changes, Erroneous and Improper Payments and Credits, and Tax Compliance Initiatives.

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

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. Please contact me at (202) 622-5916 if you have questions or Randee Cook, Acting Assistant Inspector General for Audit (Returns Processing and Account Services), at (770) 617-6434.



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***Processes to Address Erroneous Adoption Credits  
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***Processes to Address Erroneous Adoption Credits  
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***Abbreviations***

ATIN	Adoption Taxpayer Identification Number
IRS	Internal Revenue Service
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year



**Processes to Address Erroneous Adoption Credits  
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## Background

The Adoption Credit (also referred to as the Credit) is a credit to offset qualified adoption expenses, making adoption possible for some families who could not otherwise afford it. The Adoption Credit was first created in the Small Business Job Protection Act of 1996,<sup>1</sup> which provided for a nonrefundable credit for adoption expenses not to exceed \$5,000, or \$6,000 for children with special needs.<sup>2</sup> The Patient Protection and Affordable Care Act,<sup>3</sup> enacted on March 23, 2010, made the Adoption Credit refundable<sup>4</sup> and increased the maximum amount of the Credit to \$13,170 for Tax Year (TY)<sup>5</sup> 2010. Figure 1 shows the history of the Adoption Credit from TYs 2002 through 2013.

**Figure 1: History of the Adoption Credit for TYs 2002 Through 2013**

Affected Tax Year(s)	Public Law	Effects of the public law on the Adoption Credit	Credit Maximum	Allows the Adoption Credit to be indexed for inflation?	Refundability
2002 – 2009	Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) <sup>6</sup>	Temporarily increased the Adoption Credit maximum amount and allows the Credit to be indexed for inflation.	\$10,000 (for TY 2002)	Yes (by TY 2009, the Credit was \$12,150)	Nonrefundable
2010 – 2011	Patient Protection and Affordable Care Act of 2010 (PPACA)	Increases the EGTRRA Adoption Credit maximum amount and makes the Credit refundable.	\$13,170 (for TY 2010)	Yes	Refundable

<sup>1</sup> Pub. L. No. 104-188, 110 Stat. 1755 (codified as amended in 19 U.S.C., 26 U.S.C., 29 U.S.C., and 42 U.S.C.).

<sup>2</sup> A child has special needs if the child is a U.S. citizen or resident, a State determines that the child cannot or should not be returned to his or her parent’s home, and a State determines that the child probably will not be adopted unless assistance is provided.

<sup>3</sup> Pub. L. No. 111-148 124 Stat. 119 (2010) (codified as amended in scattered sections of 18 U.S.C., 20 U.S.C., 21 U.S.C., 25 U.S.C., 26 U.S.C., 28 U.S.C., 29 U.S.C., 30 U.S.C., 31 U.S.C., 35 U.S.C., and 42 U.S.C.).

<sup>4</sup> A refundable credit is not limited to the amount of an individual’s tax liability and can result in a Federal tax refund that is larger than the amount of a person’s Federal income tax withholding for that year. In contrast, a nonrefundable credit can only reduce the tax liability to zero.

<sup>5</sup> 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.

<sup>6</sup> Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of 26 U.S.C.).



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Affected Tax Year(s)	Public Law	Effects of the public law on the Adoption Credit	Credit Maximum	Allows the Adoption Credit to be indexed for inflation?	Refundability
2012	Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 <sup>7</sup>	Extends the EGTRRA Adoption Credit (Not the PPACA Adoption Credit) provisions for an additional year.	\$12,170 + (will be indexed for inflation)	Yes	Nonrefundable
2013 and beyond	N/A	Adoption Credit reverts to pre-EGTRRA levels.	\$6,000, only available for special-needs adoptions	No	Nonrefundable

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of the history of the Adoption Credit.

Figure 2 shows the number of taxpayers claiming the Adoption Credit and the amounts claimed for TYs 2008 through 2010.

**Figure 2: Total Claims for the Adoption Credit for TYs 2008 Through 2010**

Tax Year	Taxpayers Claiming Adoption Credit	Adoption Credit Claimed
2008	86,646	\$359.7 million
2009	84,297	\$339.2 million
2010 <sup>8</sup>	101,627	\$1.2 billion

Source: Internal Revenue Service (IRS) tax return volumes for TYs 2008, 2009, and 2010.

Generally, an individual may qualify for the Adoption Credit if he or she adopted a child and paid qualified expenses relating to the adoption. Qualified adoption expenses are reasonable and necessary adoption fees that include court costs, attorney fees, traveling expenses (including amounts spent for meals and lodging while away from home), and other expenses directly related to the legal adoption of an eligible child. If the individual attempts to adopt a child within the United States, he or she may be able to claim the Credit even if the adoption does not become final. If the adopted child is a U.S. citizen or resident of the United States and has special needs, the individual may qualify for the full amount of the Adoption Credit once the adoption is final, even if he or she paid few or no adoption-related expenses.

<sup>7</sup> Pub. L. No. 111-312, 124 Stat. 3296.

<sup>8</sup> Through December 2011.



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Tax law requires individuals to provide a valid identification number on their tax return for any child being claimed for the Adoption Credit. Individuals who are unable to obtain a Social Security Number for the child at the time they file their tax return can request an Adoption Taxpayer Identification Number (ATIN) from the IRS. The ATIN is a temporary identification number issued by the IRS for a child in a domestic adoption when the adopting taxpayers do not have or are unable to obtain the child’s Social Security Number. The ATIN can be used by the adopting taxpayers on their Federal income tax return to identify the child while the final adoption is pending.

**Process for Claiming the Adoption Credit and Income Exclusion for Employer-Provided Adoption Benefits**

To claim the Credit, taxpayers must file a Form 8839, *Qualified Adoption Expenses*, with their tax return. In addition to the Form 8839, taxpayers are required to attach specific adoption-related documentation. The IRS requires different documents based on whether the adoption is foreign or domestic, final or not final, and of a child with special needs or not. Appendix V provides examples of the types of acceptable documentation that a taxpayer can provide to the IRS. Figure 3 summarizes when a taxpayer may claim benefits for the Adoption Credit.

**Figure 3: When a Taxpayer May Claim Adoption Credit Benefits**

<b>Adopting a child who is a U.S. citizen or resident</b>	
<b>IF the taxpayer pays qualifying expenses in...</b>	<b>THEN the taxpayer takes the Credit in...</b>
Any year before the year the adoption is final.	The year after the year of the payment.
The year the adoption is final.	The year the adoption is final.
Any year after the year the adoption is final.	The year of the payment.

<b>Adopting a foreign child</b>	
<b>IF the taxpayer pays qualifying expenses in...</b>	<b>THEN the taxpayer takes the Credit in...</b>
Any year before the year the adoption is final.	The year the adoption is final.
The year the adoption is final.	The year the adoption is final.
Any year after the year the adoption is final.	The year of the payment.

Source: IRS guidance in the instructions for completing Form 8839 for TY 2010.



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**Individuals Can Exclude Employer-Provided Adoption Benefits From Income**

In addition to the Adoption Credit, individuals who receive assistance from their employers under a Qualified Adoption Assistance Program<sup>9</sup> to pay adoption expenses may exclude up to \$13,170 from their gross income. Special rules apply for foreign adoptions. Figure 4 shows the number of taxpayers claiming the employer-provided adoption benefit exclusion from income and the total amount claimed per year for TYs 2007 through 2009.

**Figure 4: Employer-Provided Adoption Benefit Exclusion Claimed**

<b>Tax Year</b>	<b>Taxpayers Claiming the Employer-Provided Adoption Benefit Exclusion</b>	<b>Total Exclusion Claimed</b>
2009	3,745	\$23 million
2008	4,190	\$25 million
2007	4,276	\$23 million

Source: TIGTA analysis of taxpayers with employer-provided adoption benefit exclusions.

Therefore, an individual may exclude up to \$13,170 of employer-paid adoption expenses from gross income and also claim a Credit of \$13,170 for qualified adoption expenses paid out-of-pocket. The types of expenses paid by the taxpayer’s employer are the same types of expenses that the taxpayer paid, which are those expenses directly related to the adoption of an eligible child. The difference is in the source of the payment for those expenses. The taxpayer claims the Credit for expenses paid out-of-pocket, but claims the exclusion from income for amounts paid to the taxpayer or for the taxpayer by his or her employer under a Qualified Adoption Assistance Program. Figure 5 summarizes when a taxpayer can exclude employer-provided adoption benefits from income.

**Figure 5: When a Taxpayer May Claim Expenses for Employer-Provided Adoption Benefits**

<b>Adopting a child who is a U.S. citizen or resident</b>	
<b>IF the taxpayer’s employer pays for qualifying expenses under an adoption assistance program in...</b>	<b>THEN the taxpayer takes the exclusion in...</b>
Any year.	The year of the payment.

<sup>9</sup> A Qualified Adoption Assistance Program is a separate written plan set up by an employer to provide adoption assistance to its employees.



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<b>Adopting a foreign child</b>	
<b>IF the taxpayer's employer pays for qualifying expenses under an adoption assistance program in...</b>	<b>THEN the taxpayer takes the exclusion in...</b>
Any year before the year the adoption is final.	The year the adoption is final.
The year the adoption is final.	The year the adoption is final.
Any year after the year the adoption is final.	The year of the payment.

*Source: IRS guidance in the instructions for completing Form 8839 for TY 2010.*

This review was performed at the Wage and Investment Division Headquarters in Atlanta, Georgia; the Submission Processing function offices in Lanham, Maryland, and Cincinnati, Ohio; and the Submission Processing Sites in Kansas City, Missouri, and Austin, Texas, during the period July 2011 through January 2012. 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. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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**Results of Review**

**Taxpayers Did Not Comply With Adoption Credit Documentation Requirements**

The IRS recognized that the provision in the law which made the Adoption Credit refundable could increase the risk of erroneous claims. Although the Adoption Credit provides benefits to many individuals who qualify, the unintended consequence of refundable credits is that they are often the target of unscrupulous individuals who file erroneous claims for these credits. In particular, refundable tax credits present an additional avenue for individuals to commit filing fraud. Recognizing the increased risk for erroneous claims, the IRS requires taxpayers to file a paper tax return when claiming the Adoption Credit. Each paper tax return must have a Form 8839 attached and will be reviewed by an IRS employee to ensure the documentation supporting the Adoption Credit is valid and supports the Credit claimed.

**As of December 23, 2011, the IRS received 101,627 tax returns with Adoption Credit claims totaling more than \$1.2 billion.**

In addition, the IRS also developed computer programming to ensure that:

- Taxpayers are not allowed to claim more than the maximum \$13,170 in Adoption Credit expenses for each individual child for TY 2010.
- Taxpayers are not allowed to claim the Credit or the Credit is reduced if their modified adjusted gross income exceeded a certain level.<sup>10</sup>
- Tax returns with an Adoption Credit claim are sent to the Examination function and the Adoption Credit portion of the tax refund is frozen on tax returns that were selected for audit using pre-refund filters. Some of these tax returns indicated that \*\*\*\*2(f)\*\*\*\*\*  
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Although the IRS requires taxpayers to attach documentation to their tax returns supporting Adoption Credit claims, it does not have the math error authority to deny the Credit if documentation is not provided. Without this authority, the IRS cannot deny the Credit during

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<sup>10</sup> Modified adjusted gross income is adjusted gross income modified for certain foreign income exclusions, the adoption benefit exclusion, the deduction for tuition and fees, the deduction for student loan interest, and the deduction for domestic production activities.



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## ***Processes to Address Erroneous Adoption Credits Result in Increased Taxpayer Burden and Credits Allowed to Nonqualifying Individuals***

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processing of the tax return, but must instead deny the Credit post-processing through the examination process, thereby increasing the burden for the taxpayer and the costs to the IRS.

On October 29, 2010, we recommended the IRS work with the Department of the Treasury to seek legislation from Congress for math error authority (authority to deny Adoption Credit claims at the time a tax return is processed if required documentation was not provided). The intent of our recommendation was to reduce burden and costs associated with those tax returns for which the required documentation supporting the Adoption Credit was not provided. The IRS did not agree with our recommendation and responded that it had developed and implemented sufficient filters and compliance tools to handle potential Adoption Credit fraud. We again included this recommendation in our September 2011 Filing Season<sup>11</sup> report.<sup>12</sup> IRS management agreed with this recommendation.

Math error processing would have allowed the IRS to deny claims without required documentation at the time the tax return was processed, which is less burdensome on taxpayers than the post-processing examinations. For example, using math error processing, taxpayers would have been notified of the denial of the Adoption Credit during the processing of their tax return and informed that they could provide the IRS with the necessary documentation in support of their eligibility. The IRS has a goal to resolve these responses within 30 calendar days of receipt of the information supporting the taxpayer's disagreement with the adjustment. In contrast, the IRS estimates that it takes 55 calendar days to work a piece of correspondence related to an Adoption Credit claim under review by its Examination function.

In addition to reducing taxpayer burden, math error authority would have made almost \$1.9 million available for other high-priority work in the Examination function. The IRS estimates the average direct cost to work Adoption Credit claims without valid documentation was about \$22.83 per hour and estimates the average time to work an Adoption Credit claim was 2.7 hours. As of December 2011, the IRS received 101,627 tax returns with Adoption Credit claims totaling more than \$1.2 billion. Of the 101,627 Adoption Credit claims, 43,295 (42.6 percent) were referred to the IRS's Examination function because of incomplete or missing documentation in support of the Adoption Credit claim. As of December 2011, 30,236 of the 43,295 claims sent to the Examination function were closed with the IRS's determination that the taxpayer was entitled to receive the Adoption Credit. The IRS is continuing to process claims without valid documentation in the 2012 Filing Season in the same manner.

The refundability of the Adoption Credit expired December 31, 2011, and, as of the date of this report, has not been extended by law. However, if the refundability of the Adoption Credit is extended, we believe the IRS should work with the Department of the Treasury to seek the

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<sup>11</sup> The period from January through mid-April when most individual income tax returns are filed.

<sup>12</sup> TIGTA, Ref. No. 2011-40-128, *The Passage of Late Legislation and Incorrect Computer Programming Delayed Refunds for Some Taxpayers During the 2011 Filing Season* (Sept. 2011).



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necessary legal authority to deny claims without required documentation at the time the tax return is processed.

### ***Processes Are Not Effective to Ensure Taxpayers Are Not Erroneously Receiving Adoption Credits***

Our review identified 94,092 tax returns processed through August 6, 2011, with an Adoption Credit claim and found 4,258 (4.5 percent) taxpayers received almost \$49.3 million<sup>13</sup> in Adoption Credits that were not supported by documentation. Of this, we estimate that 953 tax returns claiming Adoption Credit totaling more than \$11 million are erroneous.

#### ***Adoption Credits were issued for adoptions of foreign children that were not finalized***

Our review identified 187 taxpayers who received almost \$2.3 million in potentially erroneous Adoption Credits. Applying the percentage of cases the IRS ultimately identified as not qualifying, potentially erroneous Adoption Credit claims total almost \$390,000.<sup>14</sup> These taxpayers claimed a foreign adoption that was not final, which does not qualify for the Adoption Credit. The Internal Revenue Code<sup>15</sup> states that if the adopted child is not a U.S. citizen or resident, the taxpayer cannot take the Adoption Credit or exclude employer-provided adoption benefits from gross income until the adoption becomes final. The IRS did not develop computer programming to identify these tax returns and send them to its Examination function for review.

We alerted IRS management on November 16, 2011, that taxpayers were erroneously receiving the Adoption Credit for foreign adoptions that were not finalized. We recommended computer programming be implemented to prevent taxpayers from erroneously receiving the Adoption Credit when a foreign adoption is in process. The IRS responded that it would review the 187 tax returns to determine if the taxpayers incorrectly indicated on their tax return that the adoption was in process yet provided valid documentation indicating the foreign adoption was final. The tax returns that meet examination criteria will be referred for a post-refund audit. In addition, the IRS stated it will review the procedures and training guides to ensure the guidance provided to tax examiners is clear regarding the requirement for a foreign adoption to be final and valid documentation be attached for confirmation.

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<sup>13</sup> Consists of 187 taxpayers who received almost \$2.3 million in Adoption Credits for foreign adoptions that were not finalized, 175 taxpayers who received almost \$1.6 million in Adoption Credits even though the IRS determined the documentation was not sufficient to support the Adoption Credit claim, and 3,896 taxpayers who received almost \$45.4 million in Adoption Credits but did not provide valid documentation.

<sup>14</sup> The IRS has reviewed 76 of the 187 cases and determined that taxpayers provided valid documentation to support the Adoption Credit claim in 63 cases (a 17 percent error rate).

<sup>15</sup> I.R.C. § 36C(e).



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## ***Processes to Address Erroneous Adoption Credits Result in Increased Taxpayer Burden and Credits Allowed to Nonqualifying Individuals***

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### ***Erroneous adoption expense exclusions were allowed for adoptions of foreign children that were not finalized***

Our review identified 122 taxpayers erroneously claiming \$733,702 as an exclusion from their income for employer-provided adoption benefits relating to a foreign child adoption that was not finalized. Applying the percentage of cases the IRS ultimately identified as not qualifying, potentially erroneous Adoption Expense Exclusion claims total \$169,000.<sup>16</sup> The IRS does not have controls in place to ensure that adoptions are finalized when taxpayers claim an exclusion from income for foreign adoptions. As a result of erroneously claiming an exclusion from income, these taxpayers incorrectly reduced their income and their tax obligation. We estimate the potential tax effect of overstating their income exclusion is \$25,350 in taxes not paid.<sup>17</sup>

Instructions in the TY 2010 Form 8839 state that individuals adopting a foreign child are not allowed to claim an adoption expense exclusion until the adoption becomes final. Therefore, in the years adoption assistance is received before the foreign adoption is final, the taxpayer must add the benefit received to his or her wages. In the year the foreign adoption becomes final, the taxpayer may exclude the total employer-provided adoption benefit received over the time period of the adoption.

We alerted the IRS on January 11, 2012, and recommended that it revise procedures to ensure tax examiners verify taxpayers are not claiming an employer-provided adoption benefit exclusion from income for the adoption of a foreign child when the adoption has not been finalized. We also recommended the income exclusion claims for the 122 taxpayers be corrected and the amount of the benefit that was excluded from income be added back to income. The IRS responded that 103 of the 122 tax returns had already been referred to the Examination function. The IRS stated that the remaining tax returns either had reasons exempting them from being sent to the Examination function or the taxpayers had included adoption documentation that demonstrated the adoptions were final but had neglected to indicate this on the tax return. The IRS stated it would revise procedures for reviewing Adoption Credit claims to allow specialized IRS employees reviewing adoption documentation to accept the adoption documentation if it showed the adoption was final even if the taxpayer neglected to identify the adoption as being finalized.

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<sup>16</sup> The IRS has reviewed 101 of the 122 cases and determined that the taxpayers' claims were valid in 78 cases (a 23 percent error rate).

<sup>17</sup> The majority of the 122 cases we identified had taxable income with a marginal tax rate of 15 percent. As a result, we used a 15 percent marginal tax rate to estimate the amount of taxes that were not paid as a result of erroneous income exclusions.



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***Incorrect programming resulted in Adoption Credit claims without required documentation not being sent to the Examination function***

Our review identified 175 taxpayers who received almost \$1.6 million in Adoption Credits even though the IRS identified that these taxpayers did not include required documentation with their tax return in support of the Credit. The Adoption Credit portion of the tax refund was not frozen, and the tax returns were not referred to the Examination function as required. IRS procedures require taxpayers to attach supporting adoption documentation to their tax return substantiating the Adoption Credit claim. If the taxpayer does not attach the required documentation, the portion of the tax refund associated with the Adoption Credit is frozen and the tax return is referred to the Examination function. These 175 tax returns were unable to be processed for reasons other than the lack of required documentation to support the Adoption Credit claims and were sent to the IRS's Unpostable Unit. Once the condition that prevented the processing of the tax returns was corrected, processes were not in place to ensure these tax returns were then sent to tax examiners to review the Adoption Credit claims.

We alerted IRS management on October 31, 2011, that taxpayers were erroneously receiving the Adoption Credit without valid supporting documentation. We recommended that the IRS correspond with the taxpayers we identified as not qualified for the Adoption Credit to request that they provide valid adoption documentation. If the taxpayer does not provide the documentation, we recommended the IRS initiate recovery actions for the erroneous Adoption Credits refunded. The IRS responded that it had corrected the programming that caused the error. The 175 tax returns are being referred to the Examination function for consideration for post-refund examination.

After applying the rate (22.6 percent)<sup>18</sup> at which the Examination function review of the cases ultimately results in the taxpayer providing adequate documentation and receiving the Credit, we estimate that 40 tax returns claiming Adoption Credits totaling approximately \$358,000 are erroneous.

***Tax examiners are not always ensuring required documentation is provided in support of Adoption Credit claims***

Our review of statistically valid samples identified that 49 taxpayers erroneously received \$563,215 in Adoption Credits. We estimate 3,896 taxpayers received \$45.4 million in Adoption Credits but did not provide sufficient documentation to support their claims. After applying the rate (22.6 percent) in which the IRS Examination function review of the cases ultimately resulted in the taxpayer providing adequate documentation and receiving the Credit, we estimate that 881 tax returns claiming Adoption Credits totaling almost \$10.3 million are erroneous.

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<sup>18</sup> The IRS reported that in 30,270 (77.4 percent) of the 39,104 cases reviewed in the Examination function because of inadequate documentation, taxpayers subsequently provided valid documentation to support the Adoption Credit claim. As such, the error rate was 22.6 percent.



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## ***Processes to Address Erroneous Adoption Credits Result in Increased Taxpayer Burden and Credits Allowed to Nonqualifying Individuals***

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- ***Tax examiners incorrectly closed cases with inadequate documentation.*** Our review of a statistically valid sample of 108 tax returns referred to the Examination function identified six (5.5 percent) tax returns in which the Examination function incorrectly allowed the taxpayer to receive a refund of the Adoption Credit, even though the taxpayer had not provided sufficient documentation to support the claim. Tax examiners did not adequately review documentation to ensure the documentation supported the Adoption Credit claims. These six taxpayers erroneously received \$69,809 in Adoption Credits. As of August 6, 2011, there were 53,510 tax returns referred to the Examination function because of insufficient documentation. We estimate that 1,647 taxpayers received almost \$19.2 million in Adoption Credits but had not provided sufficient documentation to support the claims.

IRS procedures for the Examination function require a letter be sent to the taxpayer requesting required documentation to support the Adoption Credit claim. Any additional documentation provided by the taxpayer is to be reviewed to determine if the information supports the Adoption Credit claim. If the documentation is sufficient, the Adoption Credit portion of the taxpayer's refund is allowed to be released to the taxpayer. If the documentation is not sufficient, the Adoption Credit is not allowed. For the six taxpayers' claims we identified as erroneous, tax examiners did not ensure required documentation was provided supporting the adoption of all children claimed for the Adoption Credit on the individual's tax return.

- ***Tax examiners did not ensure required documentation was provided with originally filed tax returns supporting children as special-needs.*** Our review of a statistically valid sample of 105 tax returns in which the taxpayer claimed the Adoption Credit for a special-needs child identified 21 (20 percent) tax returns with insufficient documentation supporting that the child was a special-needs child. These 21 taxpayers erroneously received \$254,271 in Adoption Credits. As of August 6, 2011, there were 7,161 tax returns with Adoption Credit claims for a special-needs child. We estimate that 1,432 taxpayers received about \$17.3 million in Adoption Credits but did not provide sufficient documentation supporting that the children were special-needs children.

Notice 2010-66, *Refundable Adoption Credit*, requires taxpayers claiming the Adoption Credit for the adoption of a special-needs child to provide documentation supporting the adoption **and** documentation supporting that the child has been certified by the State as special-needs. For the 21 tax returns we determined may be erroneous, the required documentation to support the Adoption Credit claim (10 tax returns) or special-needs certification (11 tax returns) was not attached.

- ***Tax examiners did not ensure required documentation was provided with amended tax returns supporting Adoption Credit claims.*** Our review of a statistically valid sample of 100 amended tax returns with an Adoption Credit claim identified that for 22 (22 percent) of the tax returns, the required documentation was not provided in support of the claim.



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## ***Processes to Address Erroneous Adoption Credits Result in Increased Taxpayer Burden and Credits Allowed to Nonqualifying Individuals***

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These 22 taxpayers erroneously received \$239,135 in Adoption Credits. As of August 6, 2011, the IRS received 3,712 amended tax returns with a claim for the Adoption Credit. We estimate that 817 taxpayers received almost \$8.9 million in Adoption Credits but did not provide the required documentation in support of the claims.

Notice 2010-66 requires taxpayers claiming the Adoption Credit to provide documentation supporting the adoption. If the adoption is of a special-needs child, the taxpayer must also provide documentation supporting that the child has been certified by the State as special-needs. IRS procedures for the Accounts Management function were not updated to instruct tax examiners to review the Adoption Credit documentation when a claim is included with an amended tax return. In the 22 tax returns with potentially erroneous claims, the required documentation to support the Adoption Credit claim (17 tax returns) or special-needs certification (five tax returns) was not attached.

We alerted the IRS on January 6, 2012, of the results of our three statistical samples and recommended the IRS revise its procedures for the Adoption Credit to ensure that tax examiners verify that adoption documentation and special-needs certifications are adequate to support the Adoption Credit claim. In addition, we recommended that the IRS conduct training for the tax examiners to emphasize requirements for adoption documentation and special-needs certification documentation during the screening process.

IRS management responded that they had reviewed the Internal Revenue Manuals and training guides and are revising the procedures for Fiscal Year<sup>19</sup> 2012 processing of tax returns including amended tax returns with Adoption Credit claims. Management noted that the revision in procedures will ensure all tax returns that have final adoption documentation and special-needs certification documentation are sent to Examination function screeners who have received extensive tax law training and have access to examples of special-needs certificates for different States. In addition, yearly training sessions and weekly calls throughout the filing season will be held.

### ***Recommendations***

The Commissioner, Wage and Investment Division, should:

**Recommendation 1:** Develop a process to ensure that taxpayers do not erroneously receive the Adoption Credit and/or the Adoption Expense Exclusion when a foreign adoption is in process.

**Management's Response:** IRS management agreed with this recommendation. Procedures have been implemented to require that all returns with attached adoption

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<sup>19</sup> A 12-consecutive-month period ending on the last day of any month, except December. The Federal Government's fiscal year begins on October 1 and ends on September 30.



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## ***Processes to Address Erroneous Adoption Credits Result in Increased Taxpayer Burden and Credits Allowed to Nonqualifying Individuals***

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documents and with any box checked in Part 1 of Form 8839 are reviewed by Examination function classifiers. The classifiers will apply the appropriate coding to the Form 8839 based on their review of the form and supporting documentation. The Internal Revenue Manual for the Submission Processing function was updated prior to the start of the 2012 Filing Season. Training was also provided to examiners, as part of the 2012 Filing Season preparation activities, to reinforce the classification procedures and documentation requirements for each type of adoption.

**Recommendation 2:** Ensure the 187 taxpayers the TIGTA identified who received almost \$2.3 million in potentially erroneous Adoption Credits for adoptions of foreign children are reviewed in the Examination function.

**Management's Response:** IRS management agreed with this recommendation. The returns of the 187 taxpayers identified by the TIGTA were reviewed and, when warranted, were selected for examination.

**Recommendation 3:** Ensure the 175 taxpayers the TIGTA identified who received almost \$1.6 million in potentially erroneous Adoption Credits without required documentation to support the claim are reviewed in the Examination function.

**Management's Response:** IRS management agreed with this recommendation. The returns of the 175 taxpayers identified by the TIGTA were reviewed and, when warranted, were selected for examination.

### ***Some Tax Returns With Valid Adoption Credit Claims Were Incorrectly Referred to the Examination Function***

Our review identified 333 taxpayers who had valid Adoption Credit claims totaling \$2 million; however, their Adoption Credits were suspended and their tax returns were incorrectly referred to the Examination function. Of these, 286 taxpayers subsequently received their previously frozen Adoption Credits.<sup>20</sup> These taxpayers waited from five weeks to more than 25 weeks to receive the tax refund of their Adoption Credits.

IRS instructions state that individuals who provide an ATIN as an identification number for the child to be adopted are not required to attach documentation for domestic adoptions that have not been finalized. The IRS exempts these individuals from the documentation requirement because when the taxpayer submits Form W-7A, *Application for Taxpayer Identification Number for Pending U.S. Adoptions*, the taxpayer must also submit documentation to prove that the child was placed with the taxpayer for legal adoption by an authorized adoption agency. These 333 taxpayers included an ATIN as the adopted child's identifying number instead of attaching

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<sup>20</sup> As of January 6, 2012.



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***Processes to Address Erroneous Adoption Credits  
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adoption documentation, and their tax returns were incorrectly referred to the Examination function.

IRS programming was not working as intended, resulting in the incorrect identification and referral of these tax returns to the Examination function. We alerted the IRS on October 3, 2011, and recommended that the computer programming be corrected to not select tax returns when a domestic adoption is in process and the taxpayer provides an ATIN (which indicates that documentation has already been provided). IRS management responded that they appreciated the opportunity to reduce taxpayer burden and had already requested programming updates to address our concern.

***Recommendation***

The Commissioner, Wage and Investment Division, should:

***Recommendation 4:*** Ensure computer programming accurately excludes tax returns that list an ATIN(s) on Form 8839 and indicate the adoption is in process with no documentation attached to support the Adoption Credit claim so these taxpayers do not have their refunds erroneously suspended and delayed.

***Management's Response:*** IRS management agreed with this recommendation. In reviewing the disposition of returns selected, the IRS recognized the need to modify programming to exclude from selection any return where: only an ATIN is shown on Form 8839, the adoption is in process, and the only issue on the tax return is no documentation attached to support the Adoption Credit claim. Programming changes were implemented on January 3, 2012, in preparation for the 2012 Filing Season.



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***Processes to Address Erroneous Adoption Credits  
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**Appendix I**

***Detailed Objective, Scope, and Methodology***

The overall objective of this review was to assess the IRS's efforts to ensure the accuracy of Adoption Credit claims. To accomplish our objective, we:

- I. Determined if the process the IRS has in place for identifying and reviewing Adoption Credit claims effectively ensures accuracy of these claims.
  - A. Performed computer analysis<sup>1</sup> on TY<sup>2</sup> 2010 tax returns claiming the Adoption Credit processed from January 1 through August 6, 2011, to determine if the tax returns contained Adoption Credit documentation.
  - B. Assessed the effectiveness of the IRS's procedures/processes for determining whether a tax return contained the appropriate Adoption Credit documentation.
    1. Identified 39,132 tax returns the IRS determined had valid documentation supporting the Adoption Credit claim. We reviewed a statistically valid sample of 105 tax returns from 7,161 tax returns identified as of August 6, 2011, that allowed the Adoption Credit and the taxpayer indicated the adoption was for a special-needs child to determine if the claim was accurate. Our sampling criteria included a confidence level of 90 percent, a desired precision rate of  $\pm 5$  percent, and an estimated error rate equal to 10 percent. We projected the results of the statistical sample to the population.
    2. Identified 3,712 amended tax returns the IRS determined had valid documentation supporting the Adoption Credit claim and reviewed a statistically valid sample of 100 tax returns. Our sampling criteria included a confidence level of 90 percent, a desired precision rate of  $\pm 5$  percent, and an estimated error rate equal to 10 percent. We projected the results of the statistical sample to the population.
  - C. Identified 187 taxpayers claiming \$2,293,782 in Adoption Credits who claimed a foreign child and did not indicate the adoption was final.

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<sup>1</sup> To assess the reliability of computer-processed data, programmers in the TIGTA Office of Strategic Data Services validated the data that were extracted and we verified the data with appropriate documentation. Judgmental samples were reviewed to ensure that the amounts presented were supported by external sources. As appropriate, data were compared to the physical tax returns to verify that the amounts were supported.

<sup>2</sup> 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.



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***Processes to Address Erroneous Adoption Credits  
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- D. Identified 175 tax returns claiming \$1,585,892 in Adoption Credits with invalid/incomplete documentation that were not correctly sent to the Examination function.
- II. Determined whether the Examination function correctly reviewed tax returns with Adoption Credit claims that did not have valid documentation.
  - A. Determined if the Examination function correctly closed cases and allowed a refund of the Adoption Credit claimed.
    - 1. Identified 36,912 tax returns claiming the Adoption Credit that were sent to the Examination function and closed without a change to the Adoption Credit amount claimed on the tax return.
    - 2. Reviewed a statistically valid sample of 108 tax returns from 29,637 tax returns with invalid documentation identified as of August 6, 2011, that were worked in the Examination function and closed without a change to the amount of Adoption Credit claimed to determine the accuracy of the determination. Our sampling criteria included a confidence level of 90 percent, a desired precision rate of  $\pm 5$  percent, and an estimated error rate equal to 10 percent. We projected the results of the statistical sample to the population.
  - B. Assessed the timeliness of Adoption Credit claims worked by the Examination function by identifying the timeliness standards established by the Examination function and computing the average time for an Adoption Credit claim to be audited in the Examination function. This was calculated from the date the examination indicator was placed on the tax account to the time the adjustment was made or the Adoption Credit portion of the refund was released.
- III. Assessed the effectiveness of IRS processes to ensure the accuracy of taxpayers claiming an exclusion of employer-provided adoption benefits.
  - A. Identified IRS processes for verifying the accuracy of taxpayer exclusions.
  - B. Determined if taxpayers are properly claiming the exclusion from income of employer-provided adoption benefits.
    - 1. Identified 3,521 taxpayers claiming an exclusion of employer-provided adoption benefits from income.
    - 2. Matched records identified in Step III.B.1. to the Form W-2, *Wage and Tax Statement*, file to identify third-party data provided on the taxpayers' Form W-2, Box 12, with code T and determined 307 taxpayers claimed \$1,941,230 in exclusions from income but showed \$0 in employer-provided adoption benefits on the Form W-2s.



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3. Compared the exclusion of income claimed on the tax returns to the amounts reported on the Forms W-2, Box 12, with code T.
4. Determined that 122 taxpayers claiming only foreign, in-process adoptions claimed \$733,702 in exclusion from income. Taxpayers are not allowed to claim an exclusion from income for a foreign adoption until the adoption is final.

**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 the following internal controls were relevant to our audit objective: the processes for planning, organizing, directing, and controlling program operations for changes in tax legislation such as the Adoption Credit. We also evaluated the controls that are incorporated directly into computer applications to help ensure the validity, completeness, and accuracy of transactions and data during application processing of tax returns with this Credit.



***Processes to Address Erroneous Adoption Credits  
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**Appendix II**

***Major Contributors to This Report***

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)  
Russell Martin, Director  
Tina Parmer, Audit Manager  
Kathleen Hughes, Lead Auditor  
Linda Bryant, Senior Auditor  
Denise Gladson, Auditor  
Crystal Hamling, Audit Evaluator  
Arlene Feskanich, Senior Information Technology Specialist  
Brian Hattery, Senior Information Technology Specialist  
Joseph L. Katz, Ph.D., Contractor, Statistical Sampling Consultant



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***Processes to Address Erroneous Adoption Credits  
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**Appendix III**

***Report Distribution List***

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Services and Enforcement SE  
Deputy Commissioner, Services and Operations, Wage and Investment Division SE:W  
Director, Business Modernization Office, Wage and Investment Division SE:W:BMO  
Director, Customer Account Services, Wage and Investment Division SE:W:CAS  
Director, Customer Assistance, Relationships, and Education, Wage and Investment Division  
SE:W:CAR  
Director, Media and Publications, Wage and Investment Division SE:W:CAR  
Director, Return Integrity and Correspondence Services, Wage and Investment Division  
SE:W:RICS  
Director, Strategy and Finance, Wage and Investment Division SE:W:S  
Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM  
Director, Earned Income Tax Credit, Wage and Investment Division SE:W:RICS:EITC  
Director, Field Assistance, Wage and Investment Division SE:W:CAR:FA  
Director, Joint Operation Center, Wage and Investment Division SE:W:CAS:JOC  
Director, Stakeholder Partnership, Education, and Communications, Wage and Investment  
Division SE:W:CAR:SPEC  
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP  
Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PEI  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Office of Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis RAS:O  
Office of Internal Control OS:CFO:CPI:IC  
Audit Liaison: Chief, Program Evaluation and Improvement, Wage and Investment Division  
SE:W:S:PEI



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***Processes to Address Erroneous Adoption Credits  
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**Appendix IV**

***Outcome Measures***

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

For all of the outcomes listed in this Appendix, we conducted computer analyses of TY<sup>1</sup> 2010 individual income tax returns. The returns were processed by the IRS Submission Processing sites between January 1 and August 6, 2011, and were posted to the Individual Master File.<sup>2</sup>

**Type and Value of Outcome Measure:**

- Inefficient Use of Resources – Potential; \$1,863,773 per year which could be applied to other Examination function programs (see page 6).

**Methodology Used to Measure the Reported Benefit:**

During Fiscal Year<sup>3</sup> 2011, the IRS Examination function reviewed and closed 30,236 cases in which the taxpayer claimed the Adoption Credit but did not provide appropriate documentation and the case was closed without an additional tax assessment. The Examination function used 81,637 staff hours examining these cases. The IRS estimates the average direct cost to work these cases was about \$22.83 per hour. If the IRS received math error authority to disallow Adoption Credit claims without proper documentation, \$1,863,773 could be used for other Examination function programs (81,637 X \$22.83).

**Type and Value of Outcome Measure:**

- Cost Savings (Funds Put to Better Use) – Potential; 32 taxpayers erroneously received \$389,943 in Adoption Credits (see page 8).

**Methodology Used to Measure the Reported Benefit:**

We identified 187 tax returns claiming a foreign adoption that was not final and there was no change to the amount of Adoption Credit claimed during processing. The taxpayers received

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<sup>1</sup> 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.

<sup>2</sup> The IRS database that maintains transactions or records of individual tax accounts.

<sup>3</sup> A 12-consecutive-month period ending on the last day of any month, except December. The Federal Government's fiscal year begins on October 1 and ends on September 30.



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## ***Processes to Address Erroneous Adoption Credits Result in Increased Taxpayer Burden and Credits Allowed to Nonqualifying Individuals***

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potentially erroneous Adoption Credits totaling \$2,293,782. These credits should not have been allowed because the foreign adoption was still in process. Applying the rate (17 percent)<sup>4</sup> in which the Examination function review of the cases ultimately results in the taxpayer providing adequate documentation and receiving the Credit, we estimate that 32 taxpayer claims totaling \$389,943 are erroneous.

### **Type and Value of Outcome Measure:**

- Cost Savings (Funds Put to Better Use) – Potential; 40 taxpayers erroneously received \$358,412 in Adoption Credits (see page 8).

### **Methodology Used to Measure the Reported Benefit:**

Our review identified that 175 taxpayers whose tax returns either had no documentation or invalid documentation were not sent to the Examination function, and the Adoption Credit was not suspended. The IRS responded that these tax returns had prior processing problems that were corrected by programming changes, allowing the tax returns to be processed. However, the process in place at that time did not send the tax returns to the Examination function to address the Adoption Credit claims. The 175 tax returns with Adoption Credits totaling \$1,585,892 are being referred to the Examination function for consideration for post-refund review. After applying the rate (22.6 percent)<sup>5</sup> in which the Examination function review of the cases ultimately results in the taxpayer providing adequate documentation and receiving the Credit, we estimate that 40 taxpayer claims totaling \$358,412 are erroneous.

### **Type and Value of Outcome Measure:**

- Cost Savings (Funds Put to Better Use) – Potential; 881 taxpayers received potentially erroneous Adoption Credits totaling \$10,254,688 (see page 8).

### **Methodology Used to Measure the Reported Benefit:**

Our review of statistically valid samples identified that 49 taxpayers erroneously received \$563,215 in Adoption Credits. We estimate that 3,896 taxpayers received \$45,374,726 in Adoption Credits but did not provide sufficient documentation to support their claims. After applying the rate (22.6 percent) in which the IRS Examination function review of the cases ultimately resulted in the taxpayer providing adequate documentation and receiving the Credit, we estimate that 881 taxpayer claims totaling \$10,254,688 are erroneous.

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<sup>4</sup> The IRS has reviewed 76 of the 187 cases and determined that taxpayers provided valid documentation to support the Adoption Credit claim in 63 cases, resulting in a 17 percent error rate.

<sup>5</sup> The IRS reported that in 30,270 (77.4 percent) of the 39,104 cases reviewed in the Examination function because of inadequate documentation, taxpayers subsequently provided valid documentation to support the Adoption Credit claim. This resulted in a 22.6 percent error rate.



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***Processes to Address Erroneous Adoption Credits  
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**Type and Value of Outcome Measure:**

- Taxpayer Rights and Entitlements – Potential; 333 taxpayers who claimed \$2,069,654 in Adoption Credits for domestic adoptions that were not finalized and the ATINs were used for the adopted children on Form 8839, *Qualified Adoption Expenses*, were incorrectly sent to the Examination function delaying their tax refund (see page 13).

**Methodology Used to Measure the Reported Benefit:**

The 333 tax returns were sent to the Examination function in error. These tax returns should not have gone to the Examination function because the child had an ATIN and the adoption was in process. We analyzed the 333 tax returns from the date the Examination function indicator was placed on the tax account to the time the adjustment was made or the Adoption Credit portion of the tax refund was released. Of the 333 tax returns, 286 taxpayers who received a refund as of January 6, 2012, waited from five weeks to more than 25 weeks to receive the refund of their Adoption Credit. Of the remaining 47 taxpayers, 15 are still awaiting their tax refund.<sup>6</sup>

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<sup>6</sup> The remaining 32 taxpayers had their refund applied to another tax liability or there are other issues on the tax return.



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***Processes to Address Erroneous Adoption Credits  
Result in Increased Taxpayer Burden and Credits  
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**Appendix V**

***Types of Documentation Required  
for the Adoption Credit***

**Domestic and foreign adoptions that have been finalized**

Domestic or foreign adoption finalized in the United States:

- An adoption order or decree.

Foreign adoption governed by the Hague Convention and finalized in another country:

- A Hague Adoption Certificate (Immigrating Child).
- An IH-3 visa.<sup>1</sup>
- A foreign adoption decree, translated into English.

Foreign adoption from a country that is not party to the Hague Convention:

- A foreign adoption decree, translated into English.
- An IR-2<sup>2</sup> or IR-3 visa.<sup>3</sup>

**Domestic adoptions that are not final**

- An ATIN, obtained by the taxpayer for the child, included on the taxpayer's income tax return (instead of attaching a document).
- A home study completed by an authorized placement agency.
- A placement agreement with an authorized placement agency.
- A document signed by a hospital official authorizing the release of a newborn child from the hospital to the taxpayer for legal adoption.
- A court document ordering or approving the placement of a child with the taxpayer for legal adoption.

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<sup>1</sup> Issued for children with full and final adoptions from a Hague Convention country.

<sup>2</sup> Issued to a child adopted by a U.S. citizen if the child immigrates to the United States while unmarried and before his or her 21st birthday, or issued after the child's 21st birthday, if he or she is treated under the Child Status Protection Act (Pub. L. No. 107-208, 116 Stat. 927, (2002)) as if he or she were still under 21.

<sup>3</sup> Issued when a full and final adoption is completed abroad and requires that the parent(s) physically see the child prior to or during the adoption proceedings.



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- An original affidavit or notarized statement signed under penalties of perjury from an adoption attorney, government official, or other person, stating that the signor:
  - Placed or is placing a child with the taxpayer for legal adoption.
  - Is facilitating the adoption process for the taxpayer in an official capacity, summarizing the facilitation.

**Adoptions of special-needs children**

- In addition to the previously mentioned documentation, a taxpayer claiming the Adoption Credit for a child with special needs must attach a copy of the State determination of special needs.



**Processes to Address Erroneous Adoption Credits  
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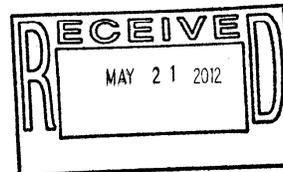
Appendix VI

**Management's Response to the Draft Report**



COMMISSIONER  
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
ATLANTA, GA 30308



May 21, 2012

MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Peggy Bogadi  
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Processes to Address Erroneous  
Adoption Credits Result in Increased Taxpayer Burden and  
Credits Allowed to Nonqualifying Individuals  
(Audit # 201140033)

The Patient Protection and Affordable Care Act of 2010 increased the maximum amount of the Adoption Credit (the Credit) and changed the nature of the Credit from non-refundable to refundable, making it one of the largest refundable credits allowed to individuals by the Tax Code. It also allowed prior year unused credit amounts to become refundable when in prior years these amounts could only be carried forward from year to year as offsets against tax liability. Our strategy for administering this Credit employed a two-pronged approach that incorporated both outreach and enforcement.

Based on the compliance risk associated with the high dollar value of the Credit, we required taxpayers to submit documentation of the adoption with their tax returns when claiming the Credit. We initiated a vigorous outreach and education campaign that included issuing formal guidance in Revenue Procedures and Notices; posting information on IRS.gov; and communicating with adoption agencies, advocacy groups, taxpayers, return preparers, and the developers of return preparation software.

Within our return processing operations, we developed and implemented filters to address known and anticipated compliance challenges. We provided training and written guidance to the employees performing the initial screening of the incoming returns, to assist them in properly identifying those returns with adequate documentation and those with inadequate or missing supporting documents. For those returns that claimed the Credit with inadequate or missing documentation, we provided intensive, specialized training to the Correspondence Examination staff to enable them to audit the returns and resolve documentation deficiencies with the taxpayers. We also



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***Processes to Address Erroneous Adoption Credits  
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conducted cross-functional, multi-level conference calls on a weekly basis to monitor processes and make real-time adjustments. As a result we successfully processed the vast majority of the returns claiming the Credit. Of the small percentage of returns that the Treasury Inspector General for Tax Administration (TIGTA) found not to have been adequately supported by documentation, we will conduct post-refund audits to determine whether the taxpayer was entitled to the credit.

During the course of the audit, we have implemented corrective actions to address issues discovered during our program reviews, as well as those TIGTA had brought to our attention. This allowed us to refine procedures and instructions to employees, which improved efficiencies in the program and resulted in better service provided to taxpayers.

Attached are our comments to your recommendations. If you have any questions, please contact me, or a member of your staff may contact Robin L. Canady, Director, Strategy and Finance, Wage and Investment Division, at (404) 338-8801.

Attachment



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***Processes to Address Erroneous Adoption Credits  
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Attachment

The Commissioner, Wage and Investment Division, should:

**RECOMMENDATION 1**

Develop a process to ensure that taxpayers do not erroneously receive the Adoption Credit and/or the Adoption Expense Exclusion when a foreign adoption is in process.

**CORRECTIVE ACTION**

We agree with this recommendation. Procedures have been implemented to require that all returns with attached adoption documents and with any box checked in Part 1 of Form 8839, *Qualified Adoption Expenses*, are reviewed by Examination classifiers. The classifiers will apply the appropriate coding to Form 8839 based on their review of the form and supporting documentation. The Internal Revenue Manual for Submission Processing was updated prior to the start of the 2012 Filing Season. Training was also provided to examiners, as part of the 2012 Filing Season preparation activities, to reinforce the classification procedures and documentation requirements for each type of adoption.

**IMPLEMENTATION DATE**

Implemented

**RESPONSIBLE OFFICIAL**

Director, Earned Income Tax Credit, Return Integrity and Correspondence 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**

Ensure the 187 taxpayers the TIGTA identified who received almost \$2.3 million in potentially erroneous Adoption Credits for adoptions of foreign children are reviewed in the Examination function.

**CORRECTIVE ACTION**

We agree with this recommendation. The returns of the 187 taxpayers identified by the Treasury Inspector General for Tax Administration (TIGTA) were reviewed and, when warranted, were selected for examination.

**IMPLEMENTATION DATE**

Implemented

**RESPONSIBLE OFFICIAL**

Director, Reporting Compliance, Compliance, Wage and Investment Division



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***Processes to Address Erroneous Adoption Credits  
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**CORRECTIVE ACTION MONITORING PLAN**

We will monitor this corrective action as part of our internal management control system.

**RECOMMENDATION 3**

Ensure the 175 taxpayers the TIGTA identified who received almost \$1.6 million in potentially erroneous Adoption Credits without required documentation to support the claim are reviewed in the Examination function.

**CORRECTIVE ACTION**

We agree with this recommendation. The returns of the 175 taxpayers identified by TIGTA were reviewed and, when warranted, were selected for examination.

**IMPLEMENTATION DATE**

Implemented

**RESPONSIBLE OFFICIAL**

Director, Reporting Compliance, Compliance, Wage and Investment Division

**CORRECTIVE ACTION MONITORING PLAN**

We will monitor this corrective action as part of our internal management control system.

The Commissioner, Wage and Investment Division, should:

**RECOMMENDATION 4**

Ensure computer programming accurately excludes tax returns that list an ATIN(s) on Form 8839 and indicate the adoption is in process with no documentation attached to support the Adoption Credit claim so these taxpayers do not have their refunds erroneously suspended and delayed.

**CORRECTIVE ACTION**

We agree with this recommendation. In reviewing the disposition of returns selected, IRS recognized the need to modify programming to exclude from selection any return where: only an Adoption Taxpayer Identification Number is shown on Form 8839; the adoption is in process; and the only issue on the tax return is no documentation attached to support the Adoption Credit Claim. Programming changes were implemented on January 3, 2012, in preparation for the 2012 Filing Season.

**IMPLEMENTATION DATE**

Implemented



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***Processes to Address Erroneous Adoption Credits  
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**RESPONSIBLE OFFICIAL**

Director, Earned Income Tax Credit, Return Integrity and Correspondence Services,  
Wage and Investment Division

**CORRECTIVE ACTION MONITORING PLAN**

We will monitor this corrective action as part of our internal management control  
system.