

IDP 15-71

**Letter Report: Overall, the Internal Revenue
Service Processed Child and Dependent Care
Credits Correctly**

July 2001

Reference Number: 2001-40-120

IDP 15-71



INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

July 23, 2001

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Pamela J. Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Letter Report - Overall, the Internal Revenue Service
Processed Child and Dependent Care Credits Correctly

This report presents the results of our review to determine if the Internal Revenue Service (IRS) correctly processed the Child and Dependent Care Credit. In summary, we found that the Internal Revenue Service (IRS) did a good job of processing 5.7 million Child and Dependent Care Credit claims totaling \$2.5 billion. It validated most of the requirements for the credit, which should significantly increase the likelihood that the credits were correct. However, the IRS did not ensure other requirements were met before allowing the credits. For example, taxpayers were allowed incorrect amounts for credits for prior year expenses.

We recommended that the Commissioner, Wage and Investment Division, evaluate why tax examiners are not disallowing the prior year portion of the Child and Dependent Care Credit when the required computation is not provided. Steps should be taken to address the problem based on the results of the evaluation. We also recommended the Commissioner, Wage and Investment Division, clarify the instructions for *Child and Dependent Care Expenses* (Form 2441) and *Child and Dependent Care Expenses for Form 1040A Filers* (Schedule 2) to ensure taxpayers understand to put the amount of the credit for the prior year expenses on the form as opposed to the amount of the expenses incurred in the prior year.

Management's response was due on July 6, 2001. As of July 13, 2001, management had not responded to the draft report.

IDP 15-71

The Treasury Inspector General for Tax Administration (TIGTA) has designated this report as Limited Official Use (LOU) pursuant to Treasury Directive TD P-71-10, Chapter III, Section 2, "Limited Official Use Information and Other Legends" of the Department of Treasury Security Manual. Because this document has been designated LOU, it may only be made available to those officials who have a need to know the information contained within this report in the performance of their official duties. This report must be safeguarded and protected from unauthorized disclosure; therefore, all requests for disclosure of this report must be referred to the Disclosure Unit within the TIGTA's Office of Chief Counsel.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Walter Arrison, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (770) 936-4590.

**Letter Report: Overall, the Internal Revenue Service
Processed Child and Dependent Care Credits Correctly**

Objective and Scope

The overall objective of this review was to determine if the Internal Revenue Service (IRS) correctly processed the Child and Dependent Care Credit. This audit is one in a series designed to evaluate the IRS' processing of tax credits commonly claimed by Wage and Investment taxpayers.¹

We performed our audit at the National Headquarters and the Atlanta and Kansas City Submission Processing Centers (ATSPC and KCSPC, respectively) between October 2000 and January 2001. We computer analyzed 5.7 million Tax Year (TY) 1999 Child and Dependent Credits that were filed nationwide between January 16 and September 9, 2000, and determined that approximately 3 million were filed electronically or at the ATSPC or KCSPC. This audit was performed in accordance with *Government Auditing Standards*.

Major contributors to this report are listed in Appendix I. Appendix II contains the Report Distribution List.

Background

The Child and Dependent Care Credit provides taxpayers relief for expenses they incur for the care of

¹ The Treasury Inspector General for Tax Administration (TIGTA) also has ongoing audits of the Adoption, Education, Elderly or the Disabled, and Mortgage Interest Credits. The TIGTA previously issued audit reports on the Earned Income Credit (*Management Advisory Report: Administration of the Earned Income Credit* (Reference Number 2000-40-160, dated September 2000)) and the Child Tax and Additional Child Tax Credits (*The Internal Revenue Service Had a Successful 2000 Filing Season; However, Opportunities Exist to More Effectively Implement Tax Law Changes* (Reference Number 2001-40-041, dated January 2001)).

**Letter Report: Overall, the Internal Revenue Service
Processed Child and Dependent Care Credits Correctly**

their children or disabled family members while they work.

The amount of the Child and Dependent Care Credit is calculated either as a percentage of the amount paid for the care (expenses are limited to \$2,400 for the care of 1 person and \$4,800 for the care of 2 or more persons) or as a percentage of earned income. This calculation is performed on Child and Dependent Care Expenses (Form 2441) or Child and Dependent Care Expenses for Form 1040A filers (Schedule 2). The maximum amount of the Child and Dependent Care Credit is \$720 for the care of 1 person and \$1,440 for the care of 2 or more persons.

Results

Overall, the IRS did a good job of processing the 5.7 million TY 1999 Child and Dependent Care Credits totaling \$2.5 billion.² It validated the accuracy of several important requirements for claiming the credit, such as maximum amounts, information about the qualifying person, earned income,³ and provider information.

However, the IRS has an opportunity to further improve its processing by ensuring that amounts claimed for prior year expenses are accurate. Also, we could not readily determine if taxpayers complied with certain other requirements before the credit was allowed because sufficient information was not provided with the Forms 2441. While the IRS could rely on subsequent examinations to validate the credits, it did not have an

² These figures represent all TY 1999 returns processed with the Child and Dependent Care Credits between January 16 and September 9, 2000 (all return data available when we obtained the electronic information for review). All subsequent references to TY 1999 returns use this same processing period.

³ Earned income is salaries, wages, tips, and other amounts received as pay for work performed.

**Letter Report: Overall, the Internal Revenue Service
Processed Child and Dependent Care Credits Correctly**

assurance that these requirements were met before taxpayers received the credits.

An overview of the requirements for receiving this credit and whether the IRS validates this information before the credit is allowed is provided in Appendix IV.

**The Internal Revenue Service Validated Most
Requirements for Claiming the Child and
Dependent Care Credit**

Maximum limit

The maximum credit is \$1,440 plus a percentage of prior year expenses. We performed a computer analysis of approximately 3 million TY 1999 returns with Child and Dependent Care Credits totaling \$1.3 billion that were processed either electronically or at the ATSPC or KCSPC. Virtually all (99.99 percent) of the credits were within the limits.⁴

*The IRS computer is
programmed to calculate
the amount of the credit.*

The IRS captured information from the Form 2441 or Schedule 2 provided by the taxpayer and re-computed the credit based on this and other information from the tax return, such as adjusted gross income. This process limited the credit amount for expenses incurred in the current year to \$720 or \$1,440, depending on the number of persons receiving care. The IRS identified and analyzed any return where the taxpayer's credit amount differed from the computer's amount.

Qualifying person

*Qualifying persons must have
a valid SSN.*

Taxpayers were required to provide the name and social security number (SSN) of the person cared for. The IRS had checks in place to ensure that this information was provided and accurate. The IRS captured information provided by the taxpayer and validated it against the IRS

⁴ We identified 395 out of 3 million tax returns with Child and Dependent Care Credits totaling \$500,000 that were over the maximum limit.

**Letter Report: Overall, the Internal Revenue Service
Processed Child and Dependent Care Credits Correctly**

computer files. Any differences were reviewed and corrected. If the IRS determined that the SSN was not valid, the credit was disallowed and a notice was sent to the taxpayer.

Earned income

Taxpayers must have earned income to qualify for the credit. The IRS had procedures to validate this requirement. The IRS captured the earned income amount provided by the taxpayer and used it when calculating the amount of the credit. If the IRS determined that the taxpayer did not have earned income, the credit was disallowed and a notice was sent to the taxpayer.

Provider information

Taxpayers were required to provide information (name, address, identifying number, and amount paid) about their childcare provider. At the time of our review, the IRS ensured that this information was provided but did not validate its accuracy. In 2001, it improved this process by adding a feature that would enable validation of the provider information. However, the programming changes were limited to only capturing the information about one provider.

Letter Report: Overall, the Internal Revenue Service
Processed Child and Dependent Care Credits Correctly

**The Internal Revenue Service Did Not Ensure
Certain Requirements Were Met Before
Allowing the Credit**

Credit for prior year expense

*Taxpayers can receive credit
for expenses they incurred in
1998 but did not pay until
1999.*

In addition to receiving a credit for the current year expenses, taxpayers can receive a credit for expenses that were incurred in the prior year but not paid until the current year.

The IRS processed 3,212 TY 1999 returns nationwide where the Child and Dependent Care Credit included a credit for the prior year expense. Our computer analysis identified 1,367 of these, totaling approximately \$943,000, that were processed either electronically or at the ATSPC or KCSPC. We reviewed a judgmental sample of 115 tax returns and determined that in 84 cases (73 percent) taxpayers were allowed \$68,510 more than they should have received, due to an incorrect computation of the credit for prior year expenses. In the remaining 31 cases, taxpayers correctly computed the credit for the prior year expenses. While we did not test the other 1,845 tax returns with the prior year expense that were processed at the other 8 IRS Submission Processing Centers, we have no reason to believe that this condition would not also exist in those other locations.

This may have occurred because the instructions for calculating the credit were not clear and taxpayers were incorrectly allowed the credit when they did not provide the supporting statement showing the calculation.

Taxpayers were instructed to write "PYE" and the amount of credit for TY 1998 expenses they paid during TY 1999 on their Form 2441 or Schedule 2. They also were required to attach a statement showing how they figured the credit. The instructions telling the taxpayer how to report the amount of the credit they can claim for prior year expenses were not clear. Taxpayers could have been confused because "PYE" is an acronym for

**Letter Report: Overall, the Internal Revenue Service
Processed Child and Dependent Care Credits Correctly**

prior year expense; however, the amount they were to enter was the *credit* for the prior year expense only, not the entire prior year expense.

Also, in a report on the IRS' 1998 Filing Season⁵ issued in August 1998, the auditors recommended that the IRS not allow the credit when the computation for the credit for prior year expenses is not provided by the taxpayer. The IRS stated in the report that to correct the problem, it issued instructions to tax examiners requiring them to disallow the prior year portion of the credit when the required computation is not provided. However, the IRS continues to have problems in this area.

The IRS does not ensure the taxpayer submitted a supporting schedule showing the calculation of the credit for prior year expense.

Recommendations

1. The Commissioner, Wage and Investment Division, should evaluate why tax examiners are not disallowing the prior year portion of the Child and Dependent Care Credit when the required computation is not provided. Steps should be taken to address the problem based on the results of the evaluation.

Management's Response: Management's response was due on July 6, 2001. As of July 13, 2001, management had not responded to the draft report.

2. The Commissioner, Wage and Investment Division, should clarify the instructions for Form 2441 and Schedule 2 to ensure taxpayers understand to put the amount of the credit for the prior year expenses on the form as opposed to the amount of the expenses incurred in the prior year.

⁵ *On-Line Review of the 1998 Filing Season* (Reference Number 085408, dated August 7, 1998).

**Letter Report: Overall, the Internal Revenue Service
Processed Child and Dependent Care Credits Correctly**

Conclusion

The IRS had checks in place to validate key requirements for claiming the Child and Dependent Care Credit. However, it could further improve its processing effectiveness by ensuring that all prior year expenses are accurate.

**Letter Report: Overall, the Internal Revenue Service
Processed Child and Dependent Care Credits Correctly**

Appendix I

Major Contributors to This Report

Walter E. Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs)

M. Susan Boehmer, Director

Deann L. Baiza, Audit Manager

Patricia H. Lee, Audit Manager

Areta Heard, Auditor

Sharla J. Robinson, Auditor

Ron Stuckey, Auditor

**Letter Report: Overall, the Internal Revenue Service
Processed Child and Dependent Care Credits Correctly**

Appendix II

Report Distribution List

Commissioner N:C
Deputy Chief Financial Officer, Department of the Treasury
Director, Customer Account Services W:CAS
Director, Electronic Tax Administration W:ETA
Director, Submission Processing W:CAS:SP
Field Director, Submission Processing (Atlanta) W:CAS:SP:AT
Field Director, Submission Processing (Kansas City) W:CAS:SP:KC

**Letter Report: Overall, the Internal Revenue Service
Processed Child and Dependent Care Credits Correctly**

Appendix III

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 the Congress.

Type and Value of Outcome Measure:

- Revenue Protection – Actual; 84 taxpayer accounts affected totaling \$68,510 (see page 5).

Methodology Used to Measure the Reported Benefit:

By querying the Internal Revenue Service computer system for tax returns filed from January 16, 2000, to September 9, 2000, we identified 3,212 TY 1999 tax returns nationwide, totaling \$2,270,440.46, that met the criteria of having a Child and Dependent Care Credit for prior year expenses greater than \$0.

From this analysis, we identified all returns filed electronically or at the Atlanta or Kansas City Submission Processing Centers. There were 1,367 returns totaling \$943,139.53. We reviewed a judgmental sample of 115 cases. Our review identified 84 returns where taxpayers were allowed incorrect credits for prior year expenses, totaling \$68,510. Our case analysis included determining the difference between the amount of the credit actually provided to the taxpayer and what the amount of the credit should have been based on the amount of the prior year expenses shown on the return. This difference represented the incorrect credit amount.

**Letter Report: Overall, the Internal Revenue Service
Processed Child and Dependent Care Credits Correctly**

Appendix IV

Requirements to Claim the Child and Dependent Care Credit

Requirement	Does the Internal Revenue Service (IRS) validate the requirement before the credit is allowed?
The Child and Dependent Care Credit should not exceed maximum limit.	Yes. The IRS' computer is programmed to calculate the credit.
Information about the qualifying individual should be included on the Form 2441 or Schedule 2.	Yes. This information is validated for accuracy. ¹
Taxpayer and spouse, if applicable, must have earned income.	Yes. If earned income is not present, the credit is disallowed. ²
A supporting statement should be attached to the return showing the computation of the credit for prior year expenses claimed.	Yes. The IRS has a requirement to disallow the credit if the statement is not attached; however, this procedure is not always followed.
Information about the care provider should be included on the Form 2441 or Schedule 2.	Yes. The IRS verifies that the information is present but does not validate the accuracy of the information.
The qualifying person must be any child under age 13 or a disabled person who can be claimed as a dependent (with exceptions) or a disabled spouse.	No. The IRS does not determine if the qualifying person is disabled or 13 years or older. ³
Expenses used to compute the credit amount must be qualifying expenses.	No. The IRS does not determine if the expenses incurred were "qualified." ⁴

¹ We reviewed the IRS' documentation for this control but did not test it to evaluate its effectiveness.

² Ibid.

³ We did not test this requirement because the taxpayer is not required to provide information on whether the person cared for is disabled on the return.

⁴ We did not test this requirement because specific information about the qualifying expenses, needed to evaluate if this requirement was met, is not provided by the taxpayer on the return. However, the IRS could rely on examinations conducted after the taxpayers receive the credit to review the requirement.