

TDP 15-71

**Letter Report: Controls During the
Processing of the Adoption Credits Help
Ensure Taxpayers Receive the Correct Benefit**

September 2001

Reference Number: 2001-40-160

TDP 15-71



INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 10, 2001

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Gordon C. Millbauer

FROM: (for) Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Letter Report – Controls During the Processing of the
Adoption Credits Help Ensure Taxpayers Receive the Correct
Benefit

This report presents the results of our review to determine if the Internal Revenue Service (IRS) correctly processed Adoption Credits.

In summary, we found that the IRS had checks in place to validate the accuracy of several of the requirements for the approximately 42,000 Adoption Credits processed during 2000. As a result, the IRS had some assurance that millions of dollars in Adoption Credits allowed were correct.

We did not make recommendations due to the low number of potentially erroneous Adoption Credits involving the maximum credit amount and adjusted gross income limits that were identified by our computer analyses. IRS management agreed with our conclusions, and the full text of their comments is included as an appendix.

The Treasury Inspector General for Tax Administration 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 Treasury Inspector General for Tax Administration'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

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M. Susan Boehmer, Acting Assistant Inspector General for Audit (Wage and Investment Income Programs), at (770) 936-4590.

**Letter Report: Controls During the Processing of the Adoption Credits
Help Ensure Taxpayers Receive the Correct Benefit**

Objective and Scope

The objective was to determine if the IRS ensured the Adoption Credit was processed correctly.

The overall objective of this review was to determine if the Internal Revenue Service (IRS) correctly processed Adoption Credits. 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 conducted our audit at the National Headquarters and the Atlanta and Kansas City Submission Processing Centers (ATSPC and KCSPC, respectively) between October 2000 and April 2001. We computer analyzed approximately 19,400 Tax Year (TY) 1999 Adoption Credits totaling over \$42 million that were processed either at these Centers or electronically between January and September 2000. 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 Adoption Credit was created to assist taxpayers with adoption expenses.

The Adoption Credit became effective in 1997. The credit was created to assist taxpayers with expenses paid for the adoption of children. Taxpayers can claim an Adoption Credit up to \$5,000 for qualified expenses

¹The Treasury Inspector General for Tax Administration (TIGTA) is currently conducting audits of the Adoption, Child and Dependent Care, 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 27, 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 31, 2001)).

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paid to adopt an eligible child.² The credit can be as much as \$6,000 if the expenses are for the adoption of a child with special needs.

Taxpayers may be able to claim the Adoption Credit if they paid qualified adoption expenses and the adoption was final in or before the year the return is filed.

Taxpayers are required to attach a *Qualified Adoption Expenses* (Form 8839) to their tax returns in order to claim the credit.

Nationwide, approximately 42,000 TY 1999 Adoption Credits, totaling approximately \$96 million, were processed by the IRS between January 2000 and September 2000.

Results

The IRS validated the accuracy of several of the requirements for the approximately 42,000 Adoption Credits processed during 2000.³ The IRS had controls in place to identify credits for more than the maximum amount allowed and those that exceeded the allowable Adjusted Gross Income (AGI) limit. It did not always correctly resolve the potential erroneous credits its computer identified when these limits were exceeded. However, our computer analysis determined that the volume of these potentially erroneous credits not properly resolved by the IRS were not material.

The IRS had controls to ensure that taxpayers reported the additional, required information about the eligible child, such as whether he/she was a child with special needs or was not a citizen or resident of the United

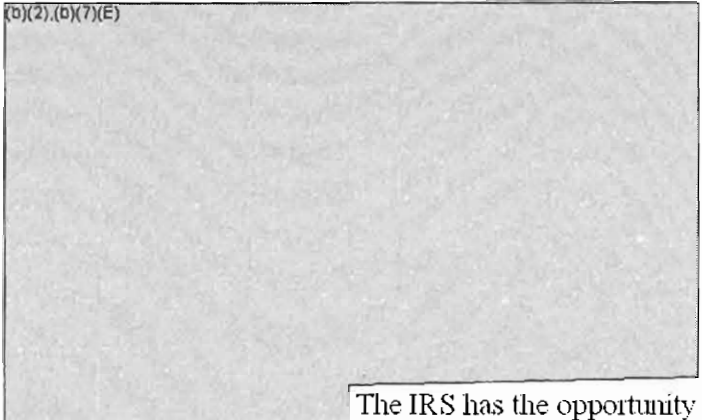
The IRS had some assurances that millions of dollars in Adoption Credits allowed were correct.

² An eligible child is a child under 18 years of age or any disabled person not able to care for himself or herself.

³ We reviewed TY 1999 returns filed with the Adoption Credit that were processed between January 16, 2000, and September 9, 2000 (all return data available when we obtained the electronic information for review). All subsequent references to TY 1999 tax returns in this report use this same processing period.

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States or possessions at the time the adoption process began. We reviewed the IRS' documentation for these controls; however, we did not test them to determine their effectiveness.



The IRS has the opportunity during compliance audits to determine if taxpayers meet these requirements.

An overview of the requirements for receiving this credit along with whether or not the IRS validated the requirements is provided in Appendix III.

The Internal Revenue Service Has Checks to Validate Several of the Requirements for the Adoption Credit

Maximum Credit Limit

Expenses are limited to \$5,000 (\$6,000 for a child with special needs).

The aggregate amount of qualified adoption expenses should not exceed \$5,000 (\$6,000 for a child with special needs).

Our computer analysis showed 283 TY 1999 tax returns totaling over \$1.8 million were processed with Adoption

⁴ We did not perform tests to determine if recommendations are needed because specific information is not required to be provided on the return.

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Credits in excess of the limit, either electronically or at the ATSPC or KCSPC.

We reviewed a judgmental sample of 50 of these tax returns and found that the IRS did not err in allowing the credits in excess of the limit on 40 (80 percent) of them because the taxpayers claimed the credits for more than one qualifying child. For the remaining 10 returns, the IRS erroneously allowed the excess credit amounts during its error resolution process, which allows it to over-ride the computer control for this error. We discussed this with IRS management and they agreed to address this procedure.

Based on the low number of potentially erroneous credits identified by our computer analysis for TY 1999 tax returns processed electronically or at the ATSPC or KCSPC that exceeded the maximum credit limit (283 of approximately 19,400 Adoption Credits), we do not believe there is a significant problem.

AGI Limit

According to the 1999 instructions for Form 8839, taxpayers' modified AGIs must be less than \$115,000 to qualify for the Adoption credit.

Our computer analysis identified only 27 of approximately 19,400 TY 1999 tax returns, totaling \$74,711, with Adoption Credits with a modified AGI greater than or equal to \$115,000 that were processed either electronically or at the ATSPC or KCSPC. We reviewed 24⁵ of these tax returns and found that in 20 (83 percent), the IRS correctly allowed the credits. The Adoption Credits claimed by these taxpayers on their TY 1999 tax returns were unused credits that were carried forward from prior tax years. The taxpayers qualified for the credits based on their AGI limit in the initial year that they claimed the credits on their tax return. For the remaining four tax returns, the IRS

⁵ We were unable to obtain the tax return for three of the cases in our sample.

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erroneously allowed the credit by over-riding the computer check. Considering there were only potentially 7 tax returns with Adoption Credits that exceeded the AGI limit out of approximately 19,400 TY 1999 Adoption Credits processed electronically or at the ATSPC or KCSPC, we do not believe there is a significant problem.

We are not making recommendations due to the low number of potentially erroneous Adoption Credits involving maximum credit amount and AGI limits that were identified by our computer analyses.

Conclusion

The IRS had several checks in place to identify potentially erroneous Adoption Credits before being allowed. These controls did not always prevent potentially erroneous credits from being allowed to taxpayers; however, since these volumes are currently low, we do not believe there is a significant problem.

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Appendix I

Major Contributors to This Report

Walter E. Arrison, Assistant Inspector General for Audit (Wage and Investment Income Programs)
M. Susan Boehmer, Director
Deann Baiza, Audit Manager
Deborah Glover, Audit Manager
Patricia Lee, Audit Manager
Gregory Dix, Senior Auditor
Yong Meador, Senior Auditor
Kathleen Hughes, Auditor
Bonnie Shanks, Auditor
Ronald Stuckey, Computer Specialist

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Appendix II

Report Distribution List

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

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Appendix III

Requirements to Claim the Adoption Credit

Requirement	Is the requirement validated before the credit is allowed?
Taxpayers are limited to \$5,000 credit per child (\$6,000 for a child with special needs).	(b)(2),(b)(7)(E)
Taxpayers' modified Adjusted Gross Incomes must be less than \$115,000.	
The eligible child is to be under age 18 and/or disabled.	
Taxpayers are to report the required information about the eligible child on the <i>Qualified Adoption Expenses</i> (Form 8839).	
The filing status can be single, head of household, qualifying widow(er) with dependent child, or married filing jointly. However, if the status is married filing separately, additional conditions need to be met.	
Taxpayers cannot claim both a credit and exclusion for the same expenses.	
Claimed expenses must be qualified adoption expenses.	

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

² We reviewed the IRS' documentation for this control but did not test this control because the IRS cannot determine if additional conditions are met by reviewing the return.

(b)(2),(b)(7)(E)

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Appendix IV

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

RECEIVED
SEP 04 2001

AUG 31 2001

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX
ADMINISTRATION

FROM: *J. M. Dalrymple*
John M. Dalrymple
Commissioner, Wage and Investment Division

SUBJECT: Draft Letter Report - "Controls During Processing of the
Adoption Credits Help Ensure Taxpayers Receive the Correct
Benefit"

I reviewed your draft report and agree with your conclusions that we have sufficient checks to assure that the Adoption Credits allowed are correct. Your report did not make any recommendations for corrective actions because the volume of credits erroneously allowed was very low and primarily due to human error. We value your input and will work to reduce these errors further.

If you have any questions, members of your staff may contact Ron Watson, Director, Customer Account Services, at 404-338-8910.

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AGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

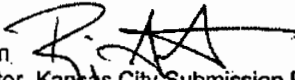
AUG 14 2001

RECEIVED

AUG 21 2001

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:

Rick Seaborn 
Acting Director, Kansas City Submission Processing Center

SUBJECT:

Draft Letter Report - Controls During the Processing of the
Adoption Credits Help Ensure Taxpayers Receive the Correct
Benefit—Urmem dated 07-30-01

We appreciate the opportunity to comment on the above report and consider the findings from the audit. We have considered the findings and concur with the results referenced on the sample audit cases.

We will continue to apply additional monitoring and internal controls over processing guidelines to ensure accuracy of return handling.

If there are any questions on this information, you may call me at (816) 823-8230, or a member of your staff may contact Shirley Amerine, Program Analyst, at (816) 823-9306.