

October 2011

# ADOPTION TAX CREDIT

## IRS Can Reduce Audits and Refund Delays

U.S. Government Accountability Office

GAO 90

YEARS

1921-2011

ACCOUNTABILITY ★ INTEGRITY ★ RELIABILITY

## Why GAO Did This Study

The federal adoption tax credit, established in 1996, was amended in 2010. These amendments included making the credit refundable (meaning taxpayers could receive payments in excess of their tax liability) and increasing the maximum allowable credit to \$13,170 of qualified adoption expenses for tax year 2010. As of August 20, 2011, taxpayers filed just under 100,000 returns, claiming about \$1.2 billion in adoption credits. Following these changes, the Internal Revenue Service (IRS) developed a strategy for processing adoption credit claims. GAO was asked to (1) describe IRS's strategy for ensuring compliance with the adoption credit for the 2011 filing season, (2) assess IRS's related communication with taxpayers and stakeholders, and (3) assess its processing and audit of claims. To conduct its analysis, GAO analyzed IRS data and documents, interviewed IRS officials, observed IRS examiners, and interviewed other stakeholders.

## What GAO Recommends

GAO recommends that IRS communicate with state and local adoption officials, provide examiners with examples of adoption assistance agreements, place the agreements on its website, and determine whether sending a letter before initiating an audit would reduce the need for audits.

IRS generally agreed with three of GAO's recommendations, but had concerns that placing sample agreements on its website may enable fraud. However, since other proof of adoption must accompany a tax credit claim, GAO believes the benefits of making these agreements available to adoptive parents outweigh the risks.

View [GAO-12-98](#) or key components. For more information, contact James R. White at (202) 512-9110 or [whitej@gao.gov](mailto:whitej@gao.gov).

# ADOPTION TAX CREDIT

## IRS Can Reduce Audits and Refund Delays

### What GAO Found

IRS's strategy for ensuring taxpayer compliance with the adoption credit included the following:

- Communicating and reaching out to taxpayers and other stakeholders, including tax professionals and adoption organizations, about new requirements.
- Requiring taxpayers seeking the adoption credit to submit proof of a completed or in-progress adoption with their return. Because taxpayers claiming the credit for a special needs child (meaning that a state determined the child cannot or should not be returned to a parent, and using specified criteria, the state can reasonably assume that the child will not be adopted without state assistance) are allowed to claim the full credit without providing documentation of adoption expenses, they also needed to provide documentation certifying the special needs status of the child.
- Requiring that returns and supporting documentation be filed on paper.
- Automatically sending returns with missing or invalid documentation for correspondence audits (audits that IRS conducts by mail).

To inform taxpayers, paid preparers and other stakeholders about new adoption credit requirements, IRS used various tools including its website, Twitter accounts, and YouTube recordings. However, IRS did not make a specific effort to communicate or convey information about documentation requirements for special needs children to state adoption managers, who administer state adoption programs. Further, IRS did not specify in training materials for its audit examiners what documentation was required to prove special needs status. IRS later revised its training materials to say that a state adoption assistance agreement (an agreement between the state and adoptive parents) was sufficient proof but did not provide samples of such agreements in the materials or place any on its website. As a consequence, taxpayers submitted a majority of returns with either no documentation or insufficient documentation.

As of August 2011, 68 percent of the nearly 100,000 returns on which taxpayers claimed the adoption credit were sent to correspondence audit. However, of the approximately 35,000 returns on which audits have been completed as of August, IRS only assessed additional tax about 17 percent of the time. The equivalent rate for all correspondence audits in 2010 was 86 percent. The time it has taken IRS to audit these predominantly legitimate adoption credit claims has resulted in considerable delays in the payment of the related refunds. For the 2012 filing season, IRS has options that might allow it to reduce the number of costly audits and issue refunds faster while still maintaining a robust enforcement strategy. One option is for IRS to immediately send a letter to taxpayers who submit returns without any documentation requesting it before initiating an audit.

This could potentially reduce the number of audits and delayed refunds, but IRS has not yet determined the extent of this impact. IRS officials acknowledged that data from the 2011 filing season experience should allow them to determine whether sending an initial letter requesting documentation would be more effective than initiating a correspondence audit.

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## Abbreviations

CPI	Consumer Price Index
FTHBC	First-Time Homebuyer Credit
HHS	Department of Health and Human Services
IRS	Internal Revenue Service
MEA	math error authority
PPACA	Patient Protection and Affordable Care Act
TIGTA	Treasury Inspector General for Tax Administration

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**G A O**

Accountability \* Integrity \* Reliability

United States Government Accountability Office  
Washington, DC 20548

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October 20, 2011

The Honorable Max Baucus  
Chairman  
Committee on Finance  
United States Senate

The Honorable Charles W. Boustany, Jr.  
Chairman  
The Honorable John Lewis  
Ranking Member  
Subcommittee on Oversight  
Committee on Ways and Means  
House of Representatives

As an incentive to encourage adoptions, since 1996 taxpayers have been able to take a tax credit for adoption-related expenses. In 2010, Congress expanded the adoption tax credit from \$10,000 to a maximum of \$13,170 and made the credit refundable for tax years 2010 and 2011, meaning taxpayers could receive payments even if their tax liability was less than the credit. Because of the changes, the Internal Revenue Service (IRS) developed a new enforcement strategy that included communication with taxpayers and stakeholders to ensure that they understood the new law and related documentation requirements. The strategy also included special screening of adoption credit claims followed by audit if the documentation was missing or looked questionable.

In this context, you asked us to

- describe IRS's strategy for ensuring taxpayer compliance with the adoption tax credit,
- assess IRS's adoption tax credit-related communication with taxpayers and stakeholders, and
- assess IRS's processing and audit of adoption tax credit claims and identify improvements, if needed, for the 2012 filing season.

For this report, we analyzed IRS information on adoption credit claims for tax year 2010 and prior years and audit work conducted during the 2011

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filing season.<sup>1</sup> We obtained and reviewed IRS plans for processing and auditing returns on which taxpayers claimed the credit and for communicating information about the credit to the public, tax professionals, and other stakeholders. We used IRS's adoption credit communication and compliance strategies as criteria for assessing IRS's performance. We interviewed IRS officials, including examiners, responsible for processing and auditing adoption credit claims and for communication. We also interviewed key outside stakeholders, including Treasury Inspector General for Tax Administration (TIGTA) officials and representatives of adoption advocacy organizations, such as the Child Welfare League of America and the North American Council for Adoptable Children. We spoke to adoption officials in five states recommended to us by the advocacy organizations to examine how states were dealing with the adoption tax credit. We spoke with IRS officials and reviewed data collection procedures and determined the data used in this report were sufficiently reliable for our purposes.

We conducted this performance audit from December 2010 through October 2011 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

The federal adoption tax credit was first authorized in the Small Business and Job Protection Act of 1996, 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> Special needs children are defined as those children who a state determined cannot or should not be returned to a parent, and using specified criteria, the state can reasonably assume that the child will not be adopted without state assistance. Parents of adoptive children with special needs are also eligible for direct assistance under Title IV-E of the Social Security Act.

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<sup>1</sup>The tax year is the year in which the tax liability is incurred and the filing season year is the year in which the taxpayer files the tax return (usually the year after the tax year).

<sup>2</sup>Pub. L. No. 104-188, title I, § 1807(a).

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Although the federal Department of Health and Human Services (HHS) oversees state administration of the payments for direct adoption assistance, the state agencies designate which children are considered to have special needs. State adoption agency managers provide guidance to adoptive families on how to manage the adoption process and frequently receive inquiries about documentation and other administrative requirements. Documentation certifying adoptions varies from state to state. In its oversight role for state adoption programs, HHS provides information to states through guidance and technical assistance. It also provides information to states and families on adoption-related issues through websites.

When the credit was first enacted in 1996, families that had qualifying expenses greater than the maximum limit for the credit could carry over that amount and claim those expenses for up to 5 years.<sup>3</sup> Also, the law phased out the credit for taxpayers above an upper income limit (which was \$182,520 in adjusted gross income for tax year 2010). Families adopting non–special needs children can claim only the amount of documented qualified expenses up to the maximum limit. However, since 2002, families adopting special needs children have been able to claim the maximum tax credit without having to document adoption expenses.

For tax years 2010 and 2011, the Patient Protection and Affordable Care Act (PPACA) of 2010 made the adoption credit refundable and set the maximum credit at \$13,170 for 2010, with the maximum amount for 2011 indexed for inflation.<sup>4</sup> The credit is scheduled to revert to a nonrefundable credit with a \$10,000 maximum for tax year 2012. For 2013 and beyond, the credit will be available only for special needs adoptions and may only be claimed for qualified expenses incurred up to a maximum of \$6,000.<sup>5</sup> See appendix I for detailed information on adoption tax credit legislation.

Since the original provision was adopted in 1996, taxpayers have claimed about \$4.28 billion in adoption tax credits. For tax year 2010, taxpayers filed almost 100,000 returns claiming the credit, with over \$1.2 billion

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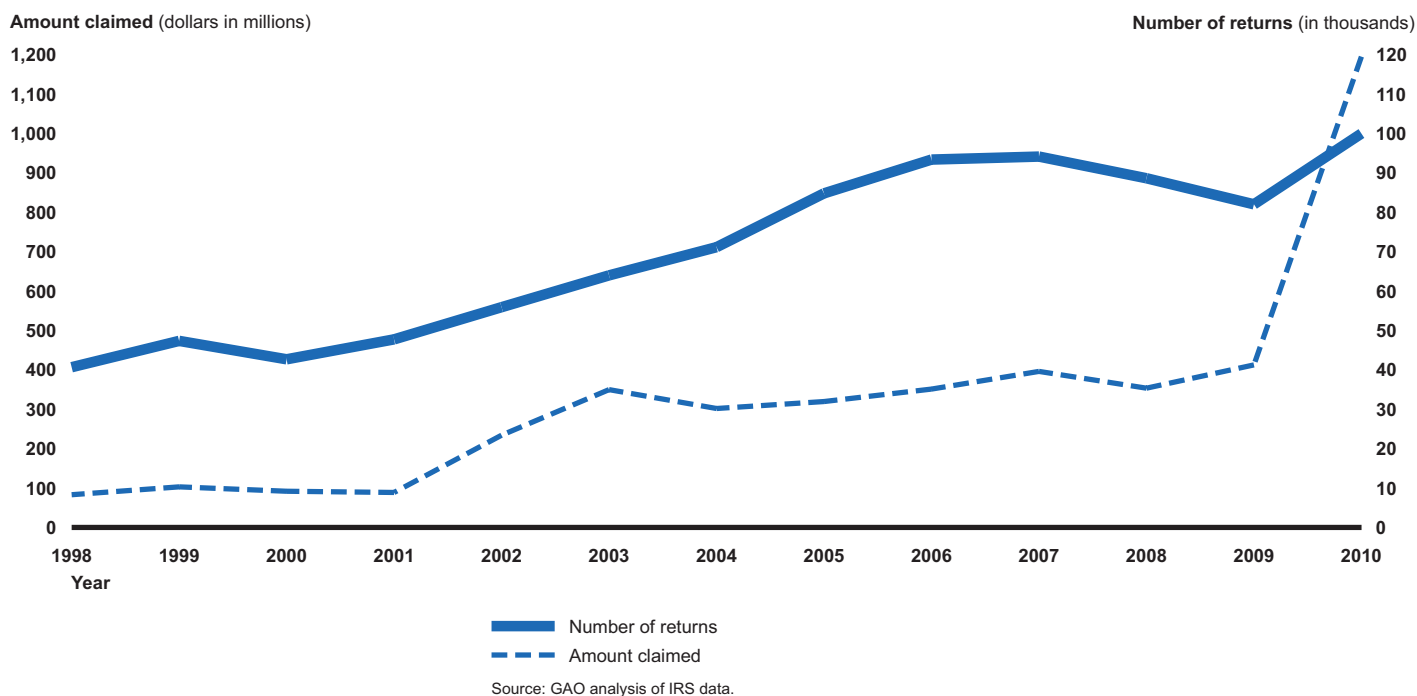
<sup>3</sup>Taxpayers claim the adoption credit using IRS Form 8839, Qualified Adoption Expenses.

<sup>4</sup>Pub. L. No. 111-148 § 10909.

<sup>5</sup>The Economic Growth and Tax Reconciliation Act of 2001, Pub. L. No. 107-16, raised the limit of the original credit to \$10,000 and does not apply to taxable years beginning after December 31, 2012.

claimed as of August 2011. Figure 1 shows the total number of claimants and amount of claims for each year since 1998.<sup>6</sup>

**Figure 1: Number and Dollar Amount of Adoption Tax Credit Claims, Tax Years 1998-2010**



We have previously reported that refundable tax credits have presented a challenge to IRS. Because taxpayers can claim refundable credits in excess of their tax liability, those attempting to commit fraud may file false claims in efforts to get improper payments from the Treasury. For example, IRS has had to deal with fraudulent claims and improper payments involving the Earned Income Tax Credit and First-Time

<sup>6</sup>Although Congress enacted the credit in 1996, available data on credit claims only goes back to 1998.



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Homebuyer Credit (FTHBC), both of which are refundable.<sup>7</sup> In such cases, Congress and IRS have taken steps to reduce the amount of fraud and improper payments while trying to minimize the number of returns that need to be audited. Audits are reviews of taxpayers' records to determine if they paid the correct amount of taxes.

As we have also previously reported, audits are costly to IRS and can create delays in delivering refunds to taxpayers because, in some cases, IRS holds the portion of the refund being audited until the audit is complete.<sup>8</sup> As an alternative to the standard audit process, Congress can approve math error authority (MEA) to allow IRS to automatically deny claims, without doing an audit, in cases where the taxpayer did not provide required documentation. In 2009, Congress approved MEA for the FTHBC, which helped significantly reduce improper payments. Having MEA allows IRS to automatically deny credit claims in instances where IRS can tell with virtual certainty that the taxpayer did not provide all of the required information and allows IRS to devote costly audit resources to other priorities.<sup>9</sup> In cases where taxpayers disagree with the credit disallowance, they may request an abatement.

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<sup>7</sup>GAO, *Financial Audit: IRS's Fiscal Years 2010 and 2009 Financial Statements*, [GAO-11-142](#) (Washington, D.C.: Nov. 10, 2010); *Improper Payments: Progress Made but Challenges Remain in Estimating and Reducing Improper Payments*, [GAO-09-628T](#) (Washington, D.C.: Apr. 22, 2009); and *First-Time Homebuyer Tax Credit: Taxpayers' Use of the Credit and Implementation and Compliance Challenges*, [GAO-10-166T](#) (Washington, D.C.: Oct. 22, 2009).

<sup>8</sup>GAO, *Recovery Act: IRS Quickly Implemented Tax Provisions, but Reporting and Enforcement Improvements Are Needed*, [GAO-10-349](#) (Washington, D.C.: Feb. 10, 2010), and *2011 Tax Filing: IRS Dealt with Challenges to Date but Needs Additional Authority to Verify Compliance*, [GAO-11-481](#) (Washington, D.C.: Mar. 29, 2011).

<sup>9</sup>MEA is statutory authority granted to IRS by Congress to correct calculation errors and other obvious instances of noncompliance, such as claims above income and credit limits, and assess additional tax based on such errors without having to issue a statutory notice of deficiency.

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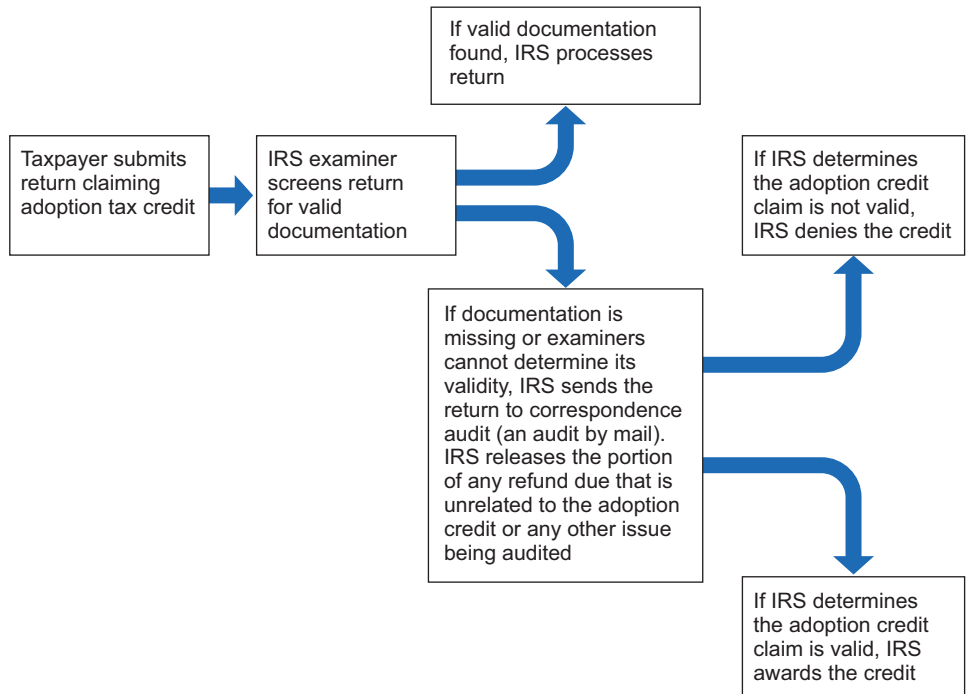
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## IRS's Adoption Tax Credit Compliance Strategy Involved Communication, Documentation, and Audit

After the changes to the adoption tax credit took effect in 2010, IRS adopted a compliance strategy to minimize improper payments and maximize accurate returns. This strategy included the following major elements:

- Communicating and reaching out to taxpayers, tax professionals, Congress, the states, and adoption organizations, with the objective of conveying information about changes in the law and documentation requirements.
- Requiring taxpayers claiming the credit to submit documentation that the adoption of the child for whom credit was being claimed was already completed or in progress (an adoption order or decree for a completed adoption, or a home study, placement agreement, hospital or court document, or lawyer's affidavit for an adoption in progress), along with IRS Form 8839.
- Requiring taxpayers claiming special needs status for their child to submit documentation from their state or local adoption authority certifying that status.
- Requiring taxpayers claiming the credit to file on paper rather than electronically so that required documentation could be included with the return.
- Screening returns for proper documentation and possible audit, as shown in figure 2.

**Figure 2: Screening of Returns on Which Taxpayers Claim the Adoption Tax Credit**



Source: GAO.

IRS’s strategy included monitoring the success of its efforts in processing tax year 2010 adoption credit claims during the 2011 filing season. IRS officials met in early October 2011 to discuss lessons learned concerning the execution of its tax year 2011 adoption credit strategy and consider changes in the strategy for next year’s filing season.

## Taxpayers and Stakeholders Did Not Have Important Information on the Adoption Tax Credit

To inform taxpayers, paid preparers, state agencies, adoption advocacy groups, and other stakeholders about the new law and documentation requirements, IRS planned to use various means of communication, such as its website, media releases, phone forums, webinars, Twitter accounts, and YouTube recordings. IRS aimed its communications at interested parties, such as paid tax preparers and adoption advocates and agencies, through, for example, specially directed e-mails, articles in professional publications, and appearances at meetings and conferences.

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However, IRS missed some opportunities to communicate on matters that later became areas of concern. For example, while IRS held a webinar on the adoption tax credit for tax professionals, IRS officials reported that because of a lack of resources they canceled the single scheduled webinar for adoption agencies and organizations that may have clarified IRS's documentation requirements for claiming the adoption credit. In addition, IRS did not make an effort to communicate to state adoption program managers or convey information about documentation requirements for claims involving special needs children, which could have helped state adoption managers better inform adoptive parents who asked them what documentation to provide to IRS.

Because of this, according to officials from adoption advocacy groups and state adoption agencies, key information about the credit did not reach some taxpayers and stakeholders, especially concerning the requirements for certification of children with special needs. As a result, according to state adoption officials and adoption organization representatives who received calls from taxpayers, IRS sent notices to many adoptive families that their returns would be subject to audit and their refunds delayed. When adoption organizations contacted IRS, the agency acknowledged a problem with its communications and the clarity of its guidance and took some corrective steps, including placing additional information about the adoption credit and special needs documentation on its website. IRS plans to take additional steps, including revising the adoption credit claim form (Form 8839) and related instructions for the 2012 filing season. However, IRS has not indicated that it plans to target future communications specifically to state and local adoption officials.

In addition, IRS did not adequately inform its tax examiners regarding certain aspects of the adoption tax credit. In particular, IRS did not specify in its examiner training materials what documentation it required and would accept to verify that adopted children had special needs status. While, in March 2011, IRS provided examiners with some examples of state adoption assistance agreements, which certify special needs status, it did not include any such examples in its training materials, even after the materials were revised in June. According to the state adoption officials with whom we spoke, the inadequate preparation of examiners led to difficulties getting IRS to accept adoption assistance agreements as proof of special needs status. For example, in response to audits and in order to get IRS to accept documentation, adoption assistance representatives from Wisconsin had to prepare a letter certifying special needs status and provide it to the families that were waiting on refunds. In

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June 2011, IRS revised its training materials and the Internal Revenue Manual to indicate that a state agreement to provide adoption assistance under Title IV-E of the Social Security Act was sufficient proof of special needs status, but did not include examples of adoption assistance agreements in the revised materials. IRS left the question of whether certification was sufficient in the absence of such an agreement up to the examiner's judgment.

According to adoption advocacy organization officials, problems persist even after the steps IRS took, with some examiners still not recognizing assistance agreements from some states as proof of special needs eligibility. Because adoption assistance agreements vary from state to state and, in some states, adoption assistance agreements are executed at the county level, adoption advocacy representatives acknowledged that IRS examiners faced challenges in identifying what documentation would be acceptable as proof of special needs status in each state. IRS took some steps to clarify what constituted sufficient documentation throughout the filing season. However, more could be done to clarify for taxpayers or its examiners what would be acceptable documentation, such as providing copies of acceptable adoption assistance agreements for each state in the revised training materials. Providing copies of state adoption assistance agreements would likely be relatively low cost, particularly since representatives from an adoption organization told us that they had provided IRS with agreements from about 40 states. Because of its role in overseeing state adoption agencies, HHS may also be able to aid IRS in reaching out to state adoption agencies.

Further, if IRS were to provide examiners with examples of adoption assistance agreements for each state, it could also post such information on its website to help taxpayers and paid tax preparers understand what constitutes acceptable documentation. The incremental cost of providing such information would likely be negligible.

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## IRS Can Reduce the Number of Audits in 2012

For the 2011 filing season, IRS screeners automatically directed all returns on which taxpayers claimed the adoption tax credit and where documentation was either missing or of uncertain validity to correspondence audit (audits by mail). A senior IRS official acknowledged that this process resulted in a large number of adoption credit-related correspondence audits and diverted IRS resources from other more productive audits.

As of August 6, 2011, IRS had sent 68 percent of almost 100,000 returns it had processed on which taxpayers claimed adoption credits to correspondence audit. Of those returns sent to audit, 83 percent were sent because of missing documentation or documentation IRS could not determine to be valid. IRS reported that it ended up disallowing all or a portion of the credit for only about 6,000 (17 percent) of the approximately 35,000 returns on which audits have been completed and assessed \$17.7 million in additional tax. This means that for 83 percent of adoption tax credit returns audited thus far, there was no change in the tax owed or refund due. Reducing the number of adoption tax credit audits would allow IRS to do more correspondence audits of other returns where the chance of assessing additional tax would be greater. To this end, all correspondence audits conducted in 2010 resulted in additional tax being assessed 86 percent of the time, compared to 17 percent for the adoption credit in 2011. Further, IRS officials also told us that they had not found any fraudulent adoption tax credit claims, and there had been no referrals of adoption tax credit claims to its Criminal Investigation unit.<sup>10</sup>

Through September 10, 2011, IRS used a disproportionate share of its audit resources on the adoption credit. IRS reported spending 32,000 staff days on adoption tax credit audits during the 2011 filing season. This represents about 3.5 percent of all staff days expended on initial review and correspondence audits. By comparison, the almost 100,000 returns filed on which taxpayers claimed the adoption tax credit as of August 20, 2011, represent less than one-tenth of 1 percent of all individual returns filed up to that point.

According to IRS officials, data for audits completed through September 2011 show that an adoption credit correspondence audit takes, on

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<sup>10</sup>A claim may be paid improperly on the basis of a claim made incorrectly or without proper documentation but in good faith; a fraudulent claim is made with intentional falsification.

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average, 74 calendar days. This delays refunds, which, according to adoption agency officials, can create difficulties for families expecting to cover adoption costs with the refund.

According to IRS officials, there are several options, each with advantages and disadvantages, for how returns on which adoption credits are claimed could be handled in the 2012 filing season. These include alternatives that could reduce costs and refund delays for claims submitted without any documentation—41 percent of claims processed as of August 2011—by either employing MEA or by sending a notice without an audit.<sup>11</sup>

- If IRS retains its 2011 strategy, it would risk again sending a relatively large proportion of adoption credit claims to audit that generate relatively low dollar amounts of assessed taxes. Doing so would likely ensure that all claims are properly documented, but would divert IRS resources from other priorities and continue to delay refunds to taxpayers.
- Alternatively, IRS could seek to obtain MEA from Congress permitting IRS to disallow the adoption tax credit without audit if a taxpayer did not supply any documentation, similar to authority granted earlier to IRS for returns on which taxpayers claimed the FTHBC. TIGTA suggested to IRS in October 2010 that it seek MEA for the adoption tax credit, and IRS and Treasury Department officials considered requesting such authority prior to the 2011 filing season. However, IRS and Treasury officials determined that current compliance tools would be sufficient. As a result, they did not request the additional authority.
- Finally, IRS could institute a procedure by which, immediately following initial screening of the return, it would send a letter to taxpayers who did not provide any documentation, notifying them of what documentation is needed.<sup>12</sup> In this case, IRS would not disallow the credit, but would instruct the taxpayer to respond to the letter within 20 days while IRS holds the return until the taxpayer responds. If the taxpayer is able to produce adequate documentation in response to the letter, the IRS examiner initially screening the return could approve the return for processing without further audit and

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<sup>11</sup>Of the remaining processed returns, 41 percent had valid documentation and 17 percent had documentation that IRS judged to be invalid.

<sup>12</sup>This is IRS Letter 0012C, which IRS refers to as a 12C letter.

taxpayers would receive refunds faster than they would if their returns were audited.<sup>13</sup> However, current procedure specifies that if the taxpayer is unable to produce the requested documentation, the return would be sent for audit so that IRS can resolve the issue. Thus, if a taxpayer did not send in documentation, his or her return would also be sent to audit, possibly creating a longer delay than with IRS's current strategy, since there would be additional time spent while IRS waited for the taxpayer to send in documentation.

IRS has not yet determined whether sending a letter upon initial screening would lead to a significant number of taxpayers submitting documentation after receiving the letter, thus reducing processing time and the number of audits. IRS officials told us that data from the 2011 filing season on the number of claimants who submitted documentation while undergoing a correspondence audit should help determine whether sending an initial letter after screening the return would be more effective.

Table 1 summarizes the options and the potential advantages and disadvantages of each.

**Table 1: IRS Options for the 2012 Filing Season**

Option	Potential advantages	Potential disadvantages
Retain 2011 strategy (review each return; do correspondence audit for all returns lacking proper documentation)	Ensures that all claims are properly documented; reduces potential for fraudulent claims and improper payments when compared to not conducting such audits	Requires substantial expenditure of time and resources for limited number of disallowed claims; causes substantial delays for taxpayers in obtaining refunds
Obtain and use MEA to disallow claims without any documentation	Potentially limits amount of resources expended on audits	Requires legislation; would require taxpayers to initiate action to obtain refunds in cases for which MEA was used and could delay refunds to those taxpayers
Send a letter to taxpayer immediately upon receipt of the tax return, with correspondence requesting documentation	If taxpayers supply requested documentation, limits amount of resources expended on audits; allows more taxpayers to obtain refunds more quickly	If taxpayers do not supply the requested documentation, may delay refunds while returns are audited

Source: GAO.

<sup>13</sup>The 12C letter instructs the taxpayer to respond within 20 days.



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## Conclusions

The adoption tax credit provides a significant source of financial assistance to adoptive families. In part because of the amount of money at stake and potential for improper payments, IRS developed a strategy for reviewing claims and administering the credit and devoted significant resources to ensuring compliance. However, in implementing this strategy IRS missed opportunities to clarify important information about what documentation it deemed acceptable, increasing the burden on taxpayers legitimately seeking the credit. Confusion about the documentation combined with the process used to send returns for correspondence audits has resulted in delaying refunds to taxpayers and the use of IRS resources that could likely be better spent elsewhere. In reviewing its strategy for the 2012 filing season, IRS has an opportunity to reduce the time and resources spent on correspondence audits of adoption tax credit claims as well as the number and length of refund delays while still maintaining a robust enforcement strategy.

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## Recommendations for Executive Action

For the 2012 filing season, we recommend that the Commissioner of Internal Revenue instruct appropriate officials to

- ensure that the communications effort specifically includes state and local adoption officials, and clarifies acceptable documentation for the certification of special needs adoptees;
- provide examples of adoption assistance agreements that meet the requirements for documenting special needs status, from each state and the District of Columbia, in training materials given to reviewers and examiners;
- place the agreements on its website to help taxpayers better understand what constitutes acceptable documentation; and
- determine whether requesting documentation in cases where no documentation is provided before initiating an audit would reduce the number of audits without significantly delaying refunds and, if so, implement such a strategy for the 2012 filing season.

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## Agency Comments and Our Evaluation

We provided a draft of this report to the Commissioner of Internal Revenue. In written comments on a draft of this report (which are reprinted in app. II) the IRS Deputy Commissioner for Services & Enforcement agreed with our recommendations to extend outreach to state adoption managers and to determine whether requesting documentation before initiating audits would reduce the number of audits without significantly delaying refunds.

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However, although he agreed that reviewers and examiners should be provided examples of adoption assistance agreements, he indicated that IRS believes current examples of state adoption assistance agreements available to examiners on an internal website are sufficient to permit them to accurately evaluate adoption records. As we stated in our report, we believe making additional examples of state adoption assistance agreements available to examiners would impose minimal incremental costs. Providing additional examples would give examiners greater certainty that taxpayers submitted the correct documentation on a state-by-state basis. Doing so would also give IRS's examiners a more comprehensive list of acceptable documentation. In developing a more comprehensive set of examples for examiners, IRS could also list the states where documentation originates from the county or local level without collecting documentation from each jurisdiction.

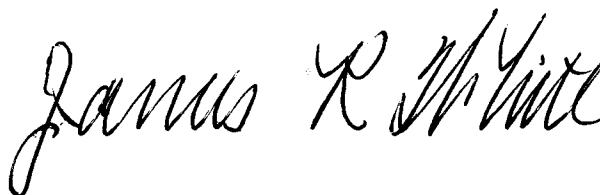
IRS also expressed concern that posting the agreements on IRS's external website might enable unscrupulous individuals to submit fraudulent documentation in support of a false claim. We understand this possibility; however, any claim for a tax credit must also be accompanied by proof that an adoption has taken place or is in progress, which would not be available on the website. Given these additional documentation requirements already in place, we believe that the benefits of making state assistance agreements available to adoptive parents on the IRS website outweigh the risks.

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As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the Chairmen and Ranking Members of other Senate and House committees and subcommittees that have appropriation, authorization, and oversight responsibilities for IRS. We will also send copies to the Commissioner of Internal Revenue, the Secretary of the Treasury, the Chairman of the IRS Oversight Board, and the Director of the Office of Management and Budget. In addition, the report will be available at no charge on the GAO website at <http://www.gao.gov>.

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If you or your staff have any questions about this report, please contact me at (202) 512-9110 or [whitej@gao.gov](mailto:whitej@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix III.

A handwritten signature in black ink that reads "James R. White". The signature is written in a cursive, flowing style.

James R. White  
Director, Tax Issues  
Strategic Issues

# Appendix I: Adoption Tax Credit Provisions, 1996 to the Present

As shown in table 2, since 1996, an adoption credit has existed. The credit has been expanded several times since 1996 and was made refundable for tax years 2010 and 2011. However, for tax year 2012 the credit is nonrefundable with a reduced maximum and reverts to the 1996 law (nonrefundable maximum of \$6,000 for special needs only) for tax year 2013 and thereafter.

**Table 2: Adoption Tax Credit Provisions, 1996 to the Present**

Year	Legislation	Amount of credit	Notes on provisions
1996	Small Business and Job Protection Act (Pub. L. No. 104-188)	Nonrefundable tax credit: \$6,000 for special needs adoptions; \$5,000 for all other adoptions	Phaseout begins at \$75,000 annual income, phased out totally at \$115,000 Allowable 5-year carryover Income exclusion for employee support Exclusion and non-special needs credit expire in 2001
2001	Economic Growth and Tax Relief Reconciliation Act (Pub. L. No. 107-16)	Nonrefundable tax credit for all adoptions; maximum set at \$10,000 and automatically increased annually based on change in the Consumer Price Index (CPI)	Initial phaseout income level set at \$150,000 per year; phaseout limits subject to CPI-based annual increase Provisions set to sunset after tax year 2010
2010	Patient Protection and Affordable Care Act (Pub. L. No. 111-148)	Refundable tax credit for all adoptions; \$13,170 for 2010, amount adjusted by CPI for 2011	Made limits on income exclusion the same as those for the credit in tax years 2010 and 2011 Postponed "sunset" of 2001 law and reversion to 1996 law until tax year 2012
2010	Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. No. 111-312)	Nonrefundable maximum \$10,000, adjusted by CPI from 2002 through 2012	Established 2001 adoption credit and employer assistance income exclusion for tax year 2012

Source: GAO.

# Appendix II: Comments from the Internal Revenue Service



DEPUTY COMMISSIONER

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

OCT 18 2011

Mr. James R. White  
Director, Tax Issues  
U.S. Government Accountability Office  
441 G Street, N.W.  
Washington, DC 20548

Dear Mr. White:

I have reviewed your draft report entitled *Adoption Tax Credit: IRS Can Reduce Audits and Refund Delays*. As your report notes, the Affordable Care Act changed the credit from a \$10,000 nonrefundable credit to a \$13,160 refundable credit for Tax Years 2010 and 2011. The value of the Adoption Credit required a comprehensive outreach and subsequent compliance strategy to administer the many unique situations for which the credit is available. The IRS implemented an approach that balanced the need for legitimate credits to be paid in a timely manner while taking steps to ensure that claims were proper.

Our outreach strategy included collaborating with external stakeholders, extensive training for our tax examiners, and updating key publications and forms. The IRS collaborated with various state agencies to identify third party data that could be used to verify legitimate domestic and special need claims. Our communication plan educated taxpayers, preparers, and adoption agencies about new Adoption Credit requirements and provided necessary guidance. Additionally, our outreach efforts included updating forms and publications, posting information on our internal and external websites, conducting public service announcements, communicating with professional preparer communities, and collaborating with software developers.

The compliance strategy included new data-driven examination filters based on research of recent return filings. In addition to our use of examination filters, the IRS required taxpayers to submit adoption documentation with their returns to mitigate the risk of fraud potential associated with the dollar amount of the credit.

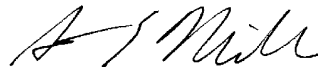
A large number of the Adoption Credit claims did not include the required documentation. In response, we issued targeted communications to remind tax preparers and taxpayers of the requirement. We also worked with tax preparation software developers to improve the guidance provided by their products, and we leveraged our relationships with large tax preparation firms to communicate the documentation issue to their preparers.

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We took steps to minimize burden on taxpayers and to avoid undue delays in issuing refunds; however, we also balanced those goals with our responsibility to protect public funds. In the coming weeks, we will examine our implementation strategy for the 2010 tax year to determine what improvements we can make for future years, and to cultivate service-wide best practices.

Responses to your specific recommendations are enclosed. If you have any questions, please contact Robin L. Canady, Director, Strategy and Finance, Wage and Investment Division, at (404) 338-8801.

Sincerely,



Steven T. Miller  
Deputy Commissioner for  
Services & Enforcement

Enclosure

Enclosure

For the 2012 filing season, we recommend that the Commissioner of Internal Revenue instruct appropriate officials to

**Recommendation 1**

Ensure that the communications effort specifically includes state and local adoption officials, and clarifies acceptable documentation for the certification of special needs adoptees.

**Comment**

We agree with this recommendation. The IRS plans to continue adoption credit outreach and education efforts. Our adoption credit communication strategy includes targeted outreach to state adoption officials and adoption organization representatives. It will highlight adoption documentation requirements and include specific messages for documentation of special needs status.

**Recommendation 2**

Provide examples of adoption assistance agreements that meet the requirements for documenting special needs status, from each state and the District of Columbia in training materials given to reviewers and examiners.

**Comment**

We agree that reviewers and examiners should be provided examples of adoption assistance agreements and the IRS has done so. As we implemented the Adoption Credit examination strategy, we recognized the need to have comprehensive adoption credit training, revisions to the Internal Revenue Manual, and information for the telephone assistors. Examiners and reviewers were trained on critical elements, such as tax law and document requirements, including special needs documentation. The IRS placed approximately 24 examples of state adoption agreements on an internal website for use by the examiners and reviewers. This website is continuously updated with new information and will remain accessible to our examiners and reviewers. We will continue to determine if additional examples should be added, but at this time believe the current examples of state adoption agreements provided to the examiners and reviewers are sufficient to permit them to accurately evaluate adoption records that are provided with tax returns in support of adoption credit claims. Due to the delegation of adoption authority by some states to the county level, and a lack of uniformity among county and state entities, it may not be feasible to provide examples of all possible adoption assistance agreements that may be encountered.

**Recommendation 3**

Place the agreements on its website to help taxpayers better understand what constitutes acceptable documentation.

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**Comment**

We agree that it is important for taxpayers to understand what is acceptable documentation. While posting examples of acceptable documentation could be helpful to taxpayers, we have significant concerns that doing so would also assist unscrupulous individuals use that information to perfect fictitious documents that would be used in making fraudulent claims for the adoption credit. We will continue to ensure that our outreach efforts are effective on this point.

**Recommendation 4**

Determine whether requesting documentation in cases where no documentation is provided before initiating an audit would reduce the number of audits without significantly delaying refunds and, if so, implement such a strategy for the 2012 filing season.

**Comment**

We agree with this recommendation. The IRS will consider whether improvements should be made to the compliance strategy implemented for the 2011 filing season. The IRS will consider whether requesting documentation prior to an audit will be beneficial or will have unintended adverse consequences on return processing that could significantly delay refunds to taxpayers.



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# Appendix III: GAO Contact and Staff Acknowledgments

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## GAO Contact

James R. White, (202) 512-9110 or [whitej@gao.gov](mailto:whitej@gao.gov)

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## Staff Acknowledgments

In addition to the contact named above, Joanna Stamatiades, Assistant Director; Steven J. Berke; Abbie David; David Fox; Tom Gilbert; Inna Livits; Kirsten Lauber; and Sabrina Streagle made key contributions to this report.

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