

The IRS's Compliance Strategy for the Expanded Adoption Credit Has Significantly and Unnecessarily Harmed Vulnerable Taxpayers, Has Increased Costs for the IRS, and Does Not Bode Well for Future Credit Administration

MSP #7

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RESPONSIBLE OFFICIAL

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DEFINITION OF PROBLEM

The adoption tax credit was created in 1996 to encourage adoption and help offset the potentially onerous costs associated with the process, particularly for low and middle income families.¹ The Patient Protection and Affordable Care Act increased the maximum credit amount under Internal Revenue Code (IRC) § 36C and made the credit fully refundable for 2010 and 2011.² The changes to the credit caused the IRS to alter its compliance strategy to focus on minimizing improper payments and stopping potentially fraudulent claims. As a result:

- During the 2012 filing season, 90 percent of returns claiming the refundable adoption credit were subject to additional review to determine if an examination was necessary.³ The most common reasons were income and a lack of documentation.
- Sixty-nine percent of all adoption credit claims during the 2012 filing season were selected for audit.⁴
- Of the completed adoption tax credit audits, over 55 percent ended with no change in the tax owed or refund due in fiscal year 2012.⁵ The median refund amount involved in these audits is over \$15,000 and the median adjusted gross income (AGI) of the taxpayers involved is about 64,000.⁶ The average adoption credit correspondence audit currently takes 126 days, causing a lengthy delay for taxpayers waiting for refunds.⁷

¹ Over 30 percent of all adopted children and over 45 percent of the children adopted from foster care live in households with incomes no higher than twice the poverty threshold. U.S. Dep't of Health and Human Services, *Adoption USA: A Chartbook Based on the 2007 National Survey of Adoptive Parents*, 60 (2009). "The high cost of adoption can be an impediment to many families wanting to adopt. With the inclusion of legal fees, court costs and charges levied by adoption agencies, the cost of an adoption can exceed \$15,000. This is a heavy burden for America's low- and middle-income families who desire to adopt. The \$5,000 adoption tax credit included in this may make the difference between a child in foster care becoming part of an adoptive family or remaining in foster care indefinitely." Louis Stokes, Extension of Remarks (Delivered May 10, 1996), Congressional Record, Volume 142, Issue 67 (May 14, 1996), E787- Adoption Promotion and Stability Act of 1996 - 104th Congress, 2nd Session.

² Pub. L. No. 111-148, § 10909, 124 Stat. 119 (2010) (codified in IRC §36 C).

³ IRS Production Report, Adoption Credit Compliance Filters Report Through Cycle 2012-38 (Through Sept. 14, 2012).

⁴ *Id.* Includes late filed 2010 returns as well as 2011 returns. IRS 7-day response (Nov. 29, 2012).

⁵ IRS Compliance Data Warehouse Automated Information Management System (AIMS) FY 2010, 2011 and 2012 (Nov. 2012).

⁶ Individual Master File (IMF), Transaction History File, Transaction Code 766 with a Credit Reference Number 261 for tax year 2010 returns processed in calendar year 2011 and tax year 2011 returns processed in calendar year 2012 and Individual Returns Transaction File tax year 2010 and 2011 from Compliance Data Warehouse (Nov. 2012).

⁷ IRS, Compliance Data Warehouse Automated Information Management System (AIMS), Project codes 355 and 423 for FY 2012 (Nov. 2012).

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- Seventy-nine percent of returns selected for audit in filing season 2012 had missing, invalid, or insufficient documentation.⁸
- Despite Congress' express intent to target the credit to low and middle income families, the IRS created income-based rules that were responsible for over one-third of all additional reviews in FY 2012.⁹
- Of the \$668.1 million in adoption credit claims in tax year (TY) 2011 as a result of adoption credit audits, the IRS only disallowed \$11 million — or one and one-half percent — in adoption credit claims.¹⁰ However, the IRS has also had to pay out \$2.1 million in interest in TY 2011 to taxpayers whose refunds were held past the 45-day period allowed by law.¹¹

TAS and the Government Accountability Office (GAO) have previously identified several specific concerns regarding the IRS's administration of the adoption credit.¹²

- The IRS did not inform taxpayers how long it would take to audit their returns and when they could expect a refund;
- The hold on the adoption credit portion of the refund caused financial burden for some eligible taxpayers;
- Auditors asked taxpayers to provide documentation before reviewing the information the taxpayers included with their original returns, so taxpayers who already submitted documentation had to send it twice;
- The inability of taxpayers to e-file returns claiming the credit resulted in delays and additional burden on taxpayers and the IRS;
- A lack of outreach has left many taxpayers unaware of their responsibilities in claiming the credit; and
- Examiners were not knowledgeable about the expanded adoption credit and how to handle the credit claimed for special needs children, thereby undermining the public policy the credit was designed to address.

⁸ Wage and Investment Division (W&I) response to TAS research request (Nov. 28, 2012). Numbers shown are for tax year 2011 returns filed in 2012 (through October 12, 2012), down slightly from 80 percent with missing, invalid, or insufficient documentation in TY 2010.

⁹ IRS Production Report, Adoption Credit Compliance Filters Report through Cycle 2012-38 (through Sept. 14, 2012). Includes late-filed 2010 returns as well as 2011 returns. A single claim can trip more than one filter.

¹⁰ W&I response to TAS research request (Nov. 16, 2012). Of the \$1.1 billion in adoption credit claims in tax year 2010 as a result of adoption credit audits, the IRS disallowed \$115 million — or ten percent — in adoption credit claims. IMF, Transaction History File, Transaction Code 766 with a Credit Reference Number 261 for tax year 2010 returns processed in calendar year 2011 and tax year 2011 returns processed in calendar year 2012 from Compliance Data Warehouse (Nov. 2012).

¹¹ IMF, Transaction History File, Transaction Codes 770, 771, 772, 776, and 777 for FY 2011 and 2012 Adoption Credit Audits in Project Codes 355 and 423 on AIMS from Compliance Data Warehouse (Nov. 2012). IRC § 6611. For a timely filed return, the IRS must pay any overpayment within 45 days from the due date of the return, or pay interest as established in IRC § 6621.

¹² National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 35-36; National Taxpayer Advocate Fiscal Year 2013 Objectives Report to Congress 46-47. GAO, GAO-12-98, *Adoption Tax Credit* (Oct. 2011).

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Administering the refundable adoption tax credit has clearly posed a challenge to the IRS, in part because it failed to consider certain administrative issues related to refundable credits, as recommended by the National Taxpayer Advocate.¹³ The large dollars at stake — up to \$13,360 in 2011¹⁴ — and potential for fraud have led to excessive delays and an inefficient use of IRS resources. The IRS's failure to engage in proactive outreach continued the cycle of problems that plagued taxpayers and the IRS. While the refundable portion of the adoption credit may have expired, the IRS must still move forward to improve its administration of the credit and learn from its mistakes.

As the National Taxpayer Advocate has noted in prior discussions of administering social policies through the Internal Revenue Code, the IRS must tailor its procedural requirements to the characteristics and capabilities of the target taxpayer population.¹⁵ With respect to the Adoption Credit, and in particular the credit for adoption of special needs children, the IRS has failed abysmally to take into account that over 45 percent of adopting families are at or below 200 percent federal poverty level, presenting particular communication and functional literacy challenges even as they are desperately in need of the funds which Congress has sought to deliver to them.¹⁶

The IRS's misguided procedures, and its failure to adequately adjust these processes when it learned its approach was seriously flawed, have caused significant economic harm to thousands of families who are selflessly trying to improve the lives of vulnerable children.¹⁷ Unless the IRS changes its approach to refundable credits and adopts more taxpayer-focused procedures, it will continue to cause problems for eligible taxpayers, including those eligible for the new refundable credit contained in the Patient Protection and Affordable Care Act — the Premium Tax Credit.¹⁸

¹³ National Taxpayer Advocate 2009 Annual Report to Congress 75 (Study: *Running Social Programs Through the Tax System*).

¹⁴ IRS, Tax Topics, *Topic 607: Adoption Credit and Adoption Assistance Programs for 2010 and 2011* available at <http://www.irs.gov/taxtopics/tc607.html> (last visited Nov. 15, 2012).

¹⁵ National Taxpayer Advocate 2010 Annual Report to Congress 15 (Most Serious Problem: *The IRS's Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs*); National Taxpayer Advocate 2009 Annual Report to Congress 75 (Study: *Running Social Programs Through the Tax System*).

¹⁶ U.S. Dep't of Health and Human Services, *Adoption USA: A Chartbook Based on the 2007 National Survey of Adoptive Parents*, 60 (2009).

¹⁷ In FY 2012, over 55 percent of adoption credit audits — over 35,000 audits — ended with no change in the tax owed or refund due. However, those taxpayers were forced to wait until the end of the audit to receive the adoption tax credit portion of their tax refund. IRS Compliance Data Warehouse Automated Information Management System (AIMS) FY 2010, 2011 and 2012 (Nov. 2012).

¹⁸ Beginning in 2014, the Affordable Care Act creates a refundable tax credit for coverage under a qualified health plan. The credit is available to eligible individuals and families with incomes below a specified threshold (subject to an income phase-out range) and subsidizes the purchase of health insurance through an exchange. IRC § 36B.

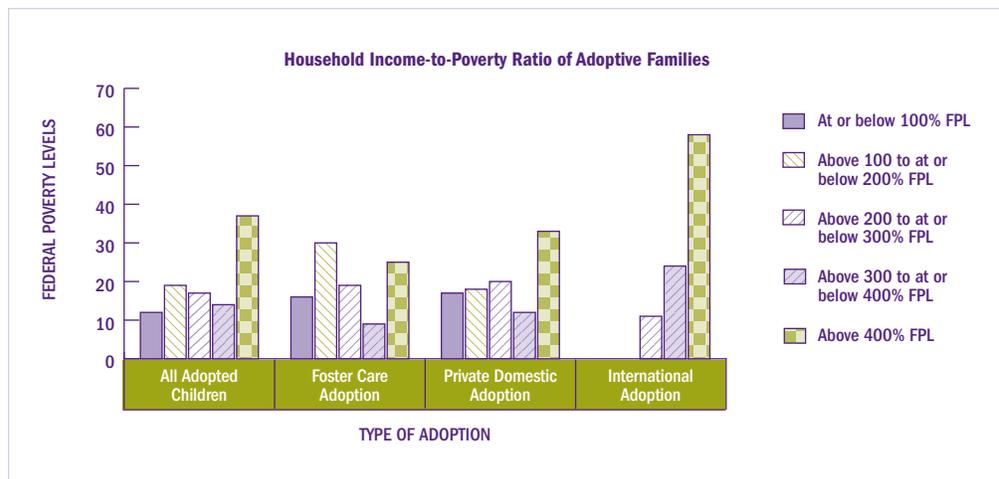
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ANALYSIS OF PROBLEM

Background

As of September 30, 2010, over 400,000 children were in foster care. Over 100,000 of them, who are awaiting adoption,¹⁹ have been in continuous foster care for an average of more than three years.²⁰ The out-of-pocket costs associated with adoption vary. Domestic adoptions through a public adoption agency can cost from zero to \$2,500. However, private and international adoptions can range from \$5,000 to more than \$40,000.²¹ As seen in Figure 1.7.1, over 30 percent of all adopted children and over 45 percent of the children adopted from foster care live in households with incomes no higher than twice the poverty threshold.²²

FIGURE 1.7.1, Household Income-to-Poverty Ratio of Adoptive Families²³



¹⁹ U.S. Dep't of Health and Human Services, *The AFCARS Report: Preliminary FY 2010 Estimates as of June 2011*, 1, 5 (June 2011).

²⁰ *Id.* at 5 (June 2011).

²¹ Child Welfare Information Gateway, *Funding Adoption: Adoption Packet 2, 2* (Feb. 2011).

²² U.S. Dep't of Health and Human Services, *Adoption USA: A Chartbook Based on the 2007 National Survey of Adoptive Parents*, 60 (2009).

²³ *Id.* Entries marked with a * indicate that the relative standard error exceeds 0.30. Percentages may not add up to 100 due to rounding.

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The Adoption Credit Was Established, in Part, to Help Offset the Cost for Low and Middle Income Families

The Adoption Tax Credit was established in 1996 to promote adoption and help offset its costs, particularly among low- and middle-income families. As noted during congressional discussion of the new credit:

... the promotion of adoption is one of the most important things we can do to strengthen American families. All children, regardless of age, sex, ethnicity, and physical and emotional health, are entitled to a family. Adoption enables children whose parents cannot or will not raise them to become part of a permanent family. Furthermore, it serves as a second chance for the thousands of children who have been removed from their families because of abuse or neglect.

The high cost of adoption can be an impediment to many families wanting to adopt. With the inclusion of legal fees, court costs and charges levied by adoption agencies, the cost of an adoption can exceed \$15,000. This is a heavy burden for America's low- and middle-income families who desire to adopt. The \$5,000 adoption tax credit included in this may make the difference between a child in foster care becoming part of an adoptive family or remaining in foster care indefinitely.²⁴

The amount of the adoption credit was increased over time, but prior to 2010, the credit was not refundable. Any credit amount in excess of a family's tax liability could only be carried forward to other years, which meant it was of less immediate value to families of moderate means. In 2008, for example, the credit was \$11,650, but only households without any other dependents and earning more than \$101,250 would have sufficient tax liability to absorb the full value.²⁵ Taxpayers of more moderate means could not recover the costs of adoption in the year they sustained them, but were forced to recoup their costs over a period of up to five years.

In 2010, as part of the Patient Protection and Affordable Care Act, Congress increased the maximum credit to \$13,170 per child and made it fully refundable for the 2010 and 2011 TYs.²⁶ This meant that even taxpayers who had no tax liability in 2010 or 2011 (or whose

²⁴ Remarks of Hon. Louis Stokes, 142 Cong. Rec. E787 (May 10, 1996). The Adoption Credit first appeared in the Adoption Promotion and Stability Act of 1996, H.R. 3296, 104th Cong., (1996), and was rolled into the Small Business 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. 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.). 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. IRC § 36C(d)(3).

²⁵ See Nathaniel S. Hibbin, *The Inequitable Tax Benefits of Adoption*, 4 Liberty Univ. L. Rev. 135, 148-9 (Fall, 2009).

²⁶ This amount increased to \$13,360 in 2011 due to inflation adjustments. The credit begins to phase out for taxpayers with modified adjusted gross income of \$185,210 and phases out completely when modified adjusted gross income exceeds \$225,210. Pub. L. No. 111-148, § 10909, 124 Stat. 119 (2010) (codified in IRC §36C); IRS, Tax Topics, *Topic 607: Adoption Credit and Adoption Assistance Programs for 2010 and 2011* available at <http://www.irs.gov/taxtopics/tc607.html> (last visited Nov. 15, 2012).

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liability was less than their credit amount) could receive the credit as a refund.²⁷ For those adopting a child with special needs, the credit is available in the year in which the adoption becomes final, regardless of the expenses (if any) the taxpayer actually incurred in connection with the adoption.²⁸ The credit is complex and has different eligibility rules depending on the type of adoption: domestic, foreign, or special needs.²⁹

To qualify for the adoption credit, an individual must have adopted a child and paid qualified expenses related to the adoption (for non-special needs adoptions). Qualified expenses are those reasonable and necessary and directly related to the legal adoption of an eligible child.³⁰ These expenses include court costs, attorney fees, and travelling expenses.³¹ To claim the credit, taxpayers must file Form 8839, *Qualified Adoption Expenses*, with their tax return and attach the required documentation.

As shown in Table 1.7.2, the number of taxpayers claiming the adoption credit and the total amount of credit claimed increased dramatically after the expansion of the credit.

TABLE 1.7.2, Adoption Credit Claims by Tax Year

	2008 ³²	2009 ³³	2010 ³⁴	2011 ³⁵
Number of Claims Filed	89,134	81,430	110,591	51,539
Total Amount Claimed	\$354.5 million	\$280.6 million	\$1.2 billion	\$668.1 million

²⁷ The refundability of the credit expired on Dec. 31, 2011, and the credit has reverted to a nonrefundable credit of up to \$12,650 for tax year 2012. Rev. Proc. 2011-52. 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. 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 Dec. 31, 2012.

²⁸ IRC § 36C(a)(3). The credit available to taxpayers who adopt children who do not have special needs is the lesser of the qualified adoption expenses they paid or incurred or the statutory maximum.

²⁹ Taxpayers may claim the adoption credit for a child who is a U.S. citizen or resident (U.S. child), children with special needs, or a foreign child. IRS Instructions for Form 8839, *Qualified Adoption Expenses* (Dec. 30, 2011).

³⁰ An eligible child for the purposes of claiming the adoption credit is an individual who has not attained age 18, or is physically or mentally incapable of caring for him/herself. IRM 4.19.15.7.1, (Nov. 29, 2011).

³¹ For a detailed discussion of qualified expenses, see Instructions to Form 8839, *Qualified Adoption Expenses*. If the individual attempts to adopt a non-special-needs 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.

³² IRS Statistics of Income (SOI) Bulletin, *Individual Income Tax Returns, Preliminary Data 2009* Figure A, Page 9 (Winter 2010).

³³ IRS SOI Bulletin, *Individual Income Tax Returns, Preliminary Data 2010* Figure A, Page 8 (Winter 2011).

³⁴ IRS, IMF, Transaction History File, Transaction Code 766 with a Credit Reference Number 261 for tax year 2010 returns processed in calendar year 2011 from Compliance Data Warehouse (Nov. 2012).

³⁵ IRS, IMF, Transaction History File, Transaction Code 766 with a Credit Reference Number 261 for tax year 2011 returns processed in calendar year 2012 from Compliance Data Warehouse (Nov. 2012).

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While the refundable portion of the credit has expired, and the credit for non-special needs adoptions ends after TY 2012, there have been efforts to extend the refundable credit.³⁶ Regardless of whether the refundable adoption credit is extended, the credit for individuals who adopt special needs children is permanent. Therefore, this discussion remains relevant as the IRS must continue to administer some portions of the adoption credit, particularly those impacting low income families.

Increased Audit Rate Burdens Both Taxpayers and the IRS and Offers Little Benefit

Given the refundability of the adoption credit and the dollars at stake, the IRS appears to have focused its efforts on enforcement and trying to stop potentially false or fraudulent credit payments rather than educating potentially eligible taxpayers and helping them claim the credit correctly. The IRS itself has admitted that it is “being very careful because it’s a big chunk of money.”³⁷ As a result, 69 percent of adoption credit claims were subject to examination in filing season 2012.³⁸

FIGURE 1.7.3, Filing Season 2012 Adoption Credit Claims vs. Examinations³⁹



³⁶ H.R. 4373, Making Adoption Affordable Act of 2012, 112th Congress 2nd Sess. (Apr. 2012). S. 3616, Making Adoption Affordable Act of 2012, 112th Congress 2nd Sess. (Sept. 2012). In addition to legislative efforts to extend the credit, a similar proposal was included in the president’s FY 2013 budget. Department of Treasury, *General Explanations of the Administration’s Fiscal Year 2013 Revenue Proposals*, 198 (Feb. 2012).

³⁷ Rosemary Parker, *Internal Revenue Service Failed to Pay Refunds for Adoption Credits on Tax Returns, Families Say*, MLive, available at http://www.mlive.com/news/index.ssf/2011/04/internal_revenue_service_faile.html (Apr. 1, 2011) (last visited Oct. 26, 2012).

³⁸ Out of all processed returns with an adoption credit claim. *IRS Production Report, Adoption Credit Compliance Filters Report Through Cycle 2012-38* (through Sept. 14, 2012). Includes late filed 2010 returns as well as 2011 returns. IRS 7-day response (Nov. 29, 2012).

³⁹ IRS Production Report, *Adoption Credit Compliance Filters Report Through Cycle 2012-38* (through Sept. 14, 2012). Includes late-filed 2010 returns as well as 2011 returns.

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IRS Adoption Credit Filters Are Flawed.

Of the tax returns that were subject to additional review, 26 percent of the delayed returns in FY 2012 were due to missing, invalid, or insufficient documentation.⁴⁰ The IRS subjected all adoption credit claims with missing or potentially invalid documentation to correspondence audit. Seventy nine percent of all adoption credit correspondence examinations in filing season 2012 involved problems with documentation.⁴¹

In addition to documentation issues, over one-third of filter breaks in FY 2012 were caused by income issues.⁴² The credit was designed, in part, to help offset the cost of adoption, and statistics show that a significant portion of individuals who adopt are lower and middle income. Yet the IRS still chose to create an income-based filter that flags the returns of the exact taxpayers the credit was designed to assist.

Despite the high number of audits, over 55 percent of adoption credit claims resulted in no change to the taxpayers' accounts during FY 2012.⁴³ *This means that more than 55 percent of taxpayers selected for audit were forced to wait 18 weeks for their refunds while the IRS verified that they were in fact entitled to the amount of the credit they claimed on their returns.*⁴⁴ The median refund amount involved in these audits is over \$15,000 and the median AGI of the taxpayers involved is about \$64,000.⁴⁵

Examination Delays Burden Taxpayers.

As with other refundable credits, once selected for examination, the IRS holds the adoption credit portion of the refund until it completes the exam process. According to the IRS, the average correspondence audit for adoption credit cases took 126 days in FY 2012. This was up from 83 days in FY 2011.⁴⁶ As a result, many taxpayers experienced delays in receiving their adoption credit — which was a potentially sizeable amount of money. In TY 2011, \$332 million in refunds were delayed as a result of adoption credit audits.⁴⁷ This amounts to half of the \$668.1 million in total adoption credit claims during the same period.⁴⁸

Some taxpayers may have been waiting on this money to help pay adoption expenses, and

⁴⁰ IRS Production Report, *Adoption Credit Compliance Filters Report Through Cycle 2012-38* (through Sept. 14, 2012). Includes late-filed 2010 returns as well as 2011 returns. A single claim can trip more than one filter.

⁴¹ W&I response to TAS research request (Nov. 28, 2012). This includes missing, invalid, or insufficient documentation. Numbers shown are for tax year 2011 returns filed in 2012 (through Oct. 12, 2012), down slightly from 80 percent with missing, invalid, or insufficient documentation in TY 2010.

⁴² IRS Production Report, *Adoption Credit Compliance Filters Report through Cycle 2012-38* (through Sept. 14, 2012). Includes late-filed 2010 returns as well as 2011 returns.

⁴³ IRS Compliance Data Warehouse AIMS FY 2011 and 2012 (Nov. 2012). The no change rate was 80 percent in FY 2011.

⁴⁴ IRS, Compliance Data Warehouse AIMS, Project codes 0355, 1067 and 0981 for FYs 2011 and 2012 (Nov. 2012).

⁴⁵ IMF, Transaction History File, Transaction Code 766 with a Credit Reference Number 261 for tax year 2011 returns processed in calendar year 2012 and Individual Returns Transaction File tax year 2011 from Compliance Data Warehouse (Nov. 2012). The median refund amount is \$15,446 and the median AGI is \$64,839 for tax year 2011.

⁴⁶ IRS, Compliance Data Warehouse AIMS, Project codes 0355, 1067 and 0981 for FYs 2011 and 2012 (Nov. 2012).

⁴⁷ W&I response to TAS research request (Nov. 16, 2012). This includes adoption credit refunds held. Amounts are rounded to the nearest million. In tax year 2010, \$850 million in refunds were delayed.

⁴⁸ IRS IMF, Transaction History File, Transaction Code 766 with a Credit Reference Number 261 for tax year 2010 returns processed in calendar year 2011 and tax year 2011 returns processed in calendar year 2012 from Compliance Data Warehouse (Nov. 2012).

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many expressed their frustration through Facebook, blogs, and tax software forums.⁴⁹ One taxpayer complained:

Filed Federal taxes in Feb. Got half of it back with a letter saying it was under review but I didn't need to send anything further. Got another letter a month later saying I needed to include a copy of the finalization (which had been included in the first round) and a "designation of special needs" letter from the county...which I can't get. We had originally sent paperwork from our adoption file that showed our child was special needs, but apparently they want a specific letter from the county. We have spent 3 months trying to get the county to return our call... So how am I supposed to get a letter from the county when the county doesn't know what they want and now won't return my calls?⁵⁰

Since 2011, the TAS Systemic Advocacy Management System (SAMS) received 39 issue submissions related to the adoption credit. The overwhelming majority of issues involved delays in processing adoption credit claims.⁵¹ In addition to alerting TAS to the delays, many taxpayers came to TAS for case assistance. For TYs 2010 and 2011, TAS has received over 9,400 cases involving the adoption credit.⁵² Of the cases TAS has closed, 86 percent were closed with the taxpayer receiving either full or partial relief.⁵³ In fact, 83 percent of taxpayers received full relief, which is significantly higher than the IRS's overall no change rate in its adoption credit cases.

IRS's Adoption Credit Cost the IRS Valuable Resources.

As noted earlier, the vast majority of adoption credit claims were due to missing or potentially invalid documentation. Rather than picking up the phone and calling taxpayers to request the missing documentation, the IRS simply sent these returns to the correspondence exam unit. The IRS has a limited pool of correspondence exam resources, a portion of which were spent on adoption credit cases. However, the data show that very few of these cases resulted in additional tax. While the complexity of the adoption credit may mean that these cases may take longer to work, the no change rate demonstrates that the IRS's

⁴⁹ There are groups on FaceBook – Adoption Tax Credit/Refund Problems and Adoption Credit Stories – dedicated to discussing problems related to the adoption tax credit.

⁵⁰ Rosemary Parker, Adoption Tax Credit Facebook Page Generates Stories of Snarled Returns, MLive, available at http://www.mlive.com/news/kalamazoo/index.ssf/2011/06/adoption_tax_credit_facebook_p.html (June 24, 2011) (last visited Oct. 26, 2012). The North American Council on Adoptable Children encourages people to share their experiences on their FaceBook page. Taxpayers noted countless problems with receiving the credit, including delays and duplicate requests for documentation. One taxpayer noted, "Ours is currently in the review process. They asked for additional documents...the same ones we submitted originally." North American Council on Adoptable Children FaceBook page, available at www.facebook.com/NACACadoption (last visited Oct. 25, 2012). The National Taxpayer Advocate has previously raised objections to the IRS's use of the term "review" in its notices, as opposed to the term "audit" because it leaves many taxpayers unaware that their return is being examined. As we have previously noted, "review" or "exam" may confuse taxpayers, but "audit" is always clear." National Taxpayer Advocate 2011 Annual Report to Congress 84 (Study: *An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*).

⁵¹ Data obtained from SAMS (Nov. 2, 2012). Analysis was of SAMS submissions from January, 2011 through October, 2012. SAMS is a database of systemic tax issues and information submitted by IRS employees and the public.

⁵² Data obtained from Taxpayer Advocate Management Information System (TAMIS) (Nov. 1, 2012).

⁵³ *Id.*

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case selection mechanism is flawed. Rather than allowing the correspondence exam group to work its traditional inventory — which has a no change rate of 15 percent in FY 2012 — the IRS's overreaction to the size and refundability of the adoption credit created a drain on resources that would have been better spent on other cases.⁵⁴

Of the \$668.1 million in adoption credit claims in TY 2011 as a result of adoption credit audits, the IRS only disallowed \$11 million — or one and one-half percent — in adoption credit claims.⁵⁵ However, the IRS has also had to pay out \$2.1 million in interest in TY 2011 to taxpayers whose refunds were held past the 45-day period allowed by law.⁵⁶ For FY 2012, the average audit results for adoption credit audits were \$1,727 compared with the overall correspondence exam average results of \$7,421 for FY 2011.⁵⁷

These meager revenue savings came at the expense of a disproportionate share of IRS correspondence exam resources, compared with the overall number of claims. GAO noted that adoption credit claims represent less than one-tenth of one percent of all individual returns for the 2011 filing season. By comparison, the IRS spent approximately 3.5 percent of its staff days on initial review and correspondence audit of adoption credit claims.⁵⁸ Additionally, the IRS reported to GAO that it did not find any fraudulent adoption credit claims or refer any cases to Criminal Investigation.⁵⁹

Documentation Issues Cause Significant Problems for Taxpayers and the IRS.

As noted earlier, for the 2012 filing season, the IRS selected 69 percent of adoption credit claims for correspondence audit — 79 percent of which involved missing or insufficient documentation.⁶⁰ Thirty-five percent of all 2011 adoption credit returns filed during the 2012 filing season had no documentation attached.⁶¹ The GAO noted a similar — but much more severe — problem in its review of the adoption credit during the 2011 filing season.⁶²

⁵⁴ IRS Compliance Data Warehouse AIMS FY 2012 (Nov. 2012).

⁵⁵ W&I response to TAS research request (Nov. 16, 2012). Of the \$1.1 billion in adoption credit claims in tax year 2010 as a result of adoption credit audits, the IRS disallowed \$115 million — or ten percent — in adoption credit claims. IMF, Transaction History File, Transaction Code 766 with a Credit Reference Number 261 for tax year 2010 returns processed in calendar year 2011 and tax year 2011 returns processed in calendar year 2012 from Compliance Data Warehouse (Nov. 2012).

⁵⁶ IMF, Transaction History File, Transaction Codes 770, 771, 772, 776, and 777 for FYs 2011 and 2012 Adoption Credit Audits in Project Codes 355 and 423 on AIMS from Compliance Data Warehouse (Nov. 2012). IRC § 6611. For a timely filed return, the IRS must pay any overpayment within 45 days from the due date of the return, or pay interest as established in IRC § 6621.

⁵⁷ IRS Compliance Data Warehouse AIMS FY 2012 Project Codes 355 and 423 (Nov. 2012); IRS, Data Book 2011 Table 9a Enforcement Coverage Page 22.

⁵⁸ GAO, GAO-12-98, *Adoption Tax Credit* (Oct. 2011). The 3.5 percent represents a total of 28 staff days. The IRS spent a total of 23,525 staff days on all correspondence exams in FY 2012. W&I response to TAS research request (Nov. 16, 2012) (extrapolation of 2,940.59 FTEs/Staff Years into staff days).

⁵⁹ GAO, GAO-12-98, *Adoption Tax Credit* 10 (Oct. 2011).

⁶⁰ IRS Production Report, Adoption Credit Compliance Filters Report Through Cycle 2012-38 (through Sept. 14, 2012). Includes late-filed 2010 returns as well as 2011 returns. IRS 7-day response (Nov. 29, 2012). W&I response to TAS research request (Nov. 28, 2012). Numbers shown are for tax year 2011 returns filed in 2012 (through Oct. 12, 2012), down slightly from 80 percent with missing, invalid, or insufficient documentation in TY 2010.

⁶¹ W&I response to TAS research request (Nov. 16, 2012).

⁶² GAO, GAO-12-98, *Adoption Tax Credit* 10 (Oct. 2011).

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Taxpayers Are Forced to Navigate Complex Documentation Rules.

The adoption credit requires taxpayers to provide substantiation at the time they file their returns — in the form of an adoption order or decree. When it first enacted the credit, Congress intended to require taxpayers “to provide *available* information about the name, age, and taxpayer identification number of each adopted child.” (Emphasis added.)⁶³ There was concern that even these minimal requirements might prove burdensome:

The conference committee is concerned that problems may arise in processing tax returns of adopting parents because of unavoidable delays involved in obtaining a social security number of a child who is being adopted. The conference understands that the Internal Revenue Service recognizes these concerns and is committed to working with the Congress to develop as soon as possible an administrative solution that *minimizes the burdens imposed on adopting parents* while balancing processing and potential compliance considerations.⁶⁴ (emphasis added)

As shown in Figure 1.7.4, the type of documentation varies depending on whether the adoption was foreign or domestic, final or in-process, and the special needs status of the child. Failure to provide documentation means the taxpayer's return will automatically be subjected to a correspondence audit.⁶⁵

⁶³ H.R. Conf. Rep. No. 104-737, 104th Cong., 2nd Sess. 1996, sec. 1807, accompanying H.R. 3448, the Small Business Job Protection Act of 1996. The substantiation provisions, which have remained the same, were:

(2) Taxpayer must include TIN.-

(A) In general. – No credit shall be allowed under this section with respect to any eligible child unless the taxpayer includes (if known) the name, age, and TIN of such child on the return of tax for the taxable year.

(B) Other methods. – The Secretary may, *in lieu of the information referred to in subparagraph (A)*, require other information meeting the purposes of subparagraph (A), including identification of an agent assisting with the adoption. (Emphasis added.)

IRC § 23(f)(2). Subsection (h) provided, and continues to provide: “Regulations. – The Secretary shall prescribe such regulations as may be appropriate to carry out this section and section 137 [pertaining to adoption assistance programs], including regulations which treat unmarried individuals who pay or incur qualified adoption expenses with respect to the same child as 1 taxpayer for purposes of applying the dollar limitation in subsection (b)(1) of this section and in section 137(b)(1).”

⁶⁴ H.R. Conf. Rep. No. 104-737, 104th Cong., 2nd Sess. 1996, sec. 1807, accompanying H.R. 3448, the Small Business Job Protection Act of 1996.

⁶⁵ This is a result of the IRS's enforcement efforts and is not a requirement of the statutory language. Some IRS examinations are conducted entirely by mail, and these examinations are known as correspondence exams. If the examination is conducted by mail, a letter is issued to the taxpayer asking for additional information about certain items shown on the tax return. Publication 3498 *The Examination Process*, (Nov. 2004).

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FIGURE 1.7.4, Documentation Requirements for Adoption Credit⁶⁶

List of documents that need to be attached to your TY 2011 return if you are claiming Adoption Credit		
If	And	Then attach a copy of
<p>Domestic Adoption <i>(Note: If the eligible child is a U.S. child, the adoption is a domestic adoption. A U.S. child is an eligible child who was a citizen or resident of the U.S. (including U.S. possessions) at the time the adoption effort began.)</i></p>	In-Process	<p>One or more of the following documents:</p> <ul style="list-style-type: none"> ◆ 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 you for legal adoption ◆ A court document ordering or approving the placement of a child with you for legal adoption ◆ An original affidavit or notarized statement signed under penalties of perjury from an adoption attorney, government official or other authorized person, stating that the signer: <ul style="list-style-type: none"> a. Placed or is placing a child with you for legal adoption, or b. Is facilitating the adoption process for you in an official capacity, with a description of the actions taken to facilitate the process. <p><i>NOTE: By its nature, either an in-process or an attempted/failed domestic adoption of a U.S. child is harder to prove than a final adoption. Notice 2010-66 contains a list of acceptable documentation, but the list is not intended to be exclusive. The adoption credit is allowable if the taxpayer can establish, by satisfactory evidence, that he or she paid qualified adoption expenses in connection with an in-process or an attempted/failed domestic adoption.</i></p>
<p>Domestic Adoption</p>	Final	The adoption certificate, order, judgment or decree clearly establishing that the adoption is final. Showing the names of the adoptive child and parent (yourself) and signed and dated by a representative of a state or county court, showing the official seal.
<p>Foreign Adoption <i>(Note: If the eligible child is a foreign child, the adoption is a foreign adoption. A foreign child is an eligible child who was not a citizen or resident of the U.S. (including U.S. possessions) at the time the adoption effort began.)</i></p>	In-Process	The adoption credit cannot be claimed.
<p>Foreign Adoption <i>(from a country governed by the Hague Convention)</i></p>	Final	<p>One or more of the following:</p> <p>The Hague Adoption Certificate (Immigrating Child)</p> <ul style="list-style-type: none"> ◆ The IH-3 visa, or ◆ a foreign adoption decree translated into English.
<p>Foreign Adoption <i>(from a country that is not a party to the Hague Convention)</i></p>	Final	<p>One or more of the following documents:</p> <ul style="list-style-type: none"> ◆ A foreign adoption decree translated into English; or ◆ An IR-2 or IR-3 visa.
<p>Domestic Adoption <i>(special needs child)</i></p>	Final	<p>The following documents:</p> <ul style="list-style-type: none"> ◆ An adoption certificate, report or final decree clearly reestablishing that the adoption is final, showing the names of the adoptive child and parent (yourself) and signed and dated by a representative of the state court, <i>and</i> ◆ A copy of the state's determination of special needs, which may include, but is not limited to the following: <ul style="list-style-type: none"> a. A signed adoption assistance or subsidy agreement issued by the state. b. Certification from the state or a county welfare agency verifying that the child is approved to receive adoption assistance. c. Certification from the state or a county welfare agency verifying that the child has special needs.

The documentation that certifies adoptions varies from state to state. A determination of whether a child is considered to have special needs is also a state-based decision. The result

⁶⁶ <http://www.irs.gov/Individuals/Adoption-Credit-Documentation-Requirements>.

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is a variety of documentation that may meet the requirements for the adoption credit. As we have seen with the Earned Income Tax Credit (EITC), when taxpayers are required to provide non-standardized documentation to establish eligibility, it often leads to problems for both taxpayers and the IRS.⁶⁷

The IRS is Unable to Quickly Address Documentation Issues or Identify Whether Provided Documentation is Sufficient.

As noted earlier, Congress specifically stated that it wanted to minimize the burden on adoptive parents when it imposed documentation requirements. However, the IRS's action in automatically sending claims that lack sufficient documentation to correspondence exam is the exact opposite of Congress's intent. The IRS could develop a way to quickly reach out to taxpayers to address the documentation problem, but instead chose the more burdensome and time-intensive approach. Once again, the IRS failed to look at the impacted taxpayers and design a compliance strategy around their particular needs and characteristics. Instead, it relied on its traditional processes and increased burden for taxpayers and its own employees.

While some taxpayers simply failed to provide any documentation, the IRS experienced problems identifying whether documentation was sufficient. In its audit, GAO spoke with adoption agency representatives that "acknowledged that IRS examiners faced challenges in identifying what documentation would be acceptable as proof of special needs status in each state."⁶⁸

The National Taxpayer Advocate is encouraged that the IRS took steps to update training materials for examiners and provide examples of acceptable assistance agreements for most states. However, the IRS failed to provide the same documentation samples to taxpayers and practitioners. In its response to the GAO audit, the IRS claimed such examples could lead to fraud. As GAO noted, even if someone used the sample documentation to file a fraudulent adoption credit claim, the person still needs to provide sufficient proof of adoption expenses to qualify for the credit. The sample documentation — on its own — is not sufficient to result in a fraudulent claim. Given the significant percentage of adoption credit audits that result from documentation problems and the costs to both taxpayers and the IRS — the benefits of providing sample documentation clearly outweigh the risks.

Additionally, given the difficulties the IRS experiences with the various third-party forms, the IRS should develop a standard affidavit form that taxpayers could complete and have signed and certified by a designated official, to establish the critical information needed to

⁶⁷ National Taxpayer Advocate 2007 Annual Report to Congress 94-116 (Study: *EIC Audits – A Challenge to Taxpayers*); National Taxpayer Advocate 2006 Annual Report to Congress 289-310 (Most Serious Problem: *Correspondence Exams*); National Taxpayer Advocate 2005 Annual Report to Congress 94-122 (Most Serious Problem: *Earned Income Tax Credit Exam Issues*); National Taxpayer Advocate 2002 Annual Report to Congress 47-54 (Most Serious Problem: *EITC Eligibility Determination Can Be Made Less Burdensome*); National Taxpayer Advocate 2002 Annual Report to Congress 75-80 (Most Serious Problem: *The Length of EITC Audits Contributes to Taxpayers Concerns*); National Taxpayer Advocate 2002 Annual Report to Congress 81-87 (Most Serious Problem: *EITC Recertification Compounds Taxpayer Burden*).

⁶⁸ GAO, GAO-12-98, *Adoption Tax Credit* 9 (Oct. 2011).

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establish eligibility for the credit. The IRS has undertaken similar efforts with the affidavit designed for the EITC pre-certification study.⁶⁹ Generally, this pilot program found affidavits more reliable than traditionally accepted documents: “Affidavits were believed to be easier for taxpayers to obtain than official documents or letters. The results show that affidavits had a higher acceptance rate than the other two types of documents.”⁷⁰

Additionally, as observed by GAO, the IRS failed to adequately cooperate with state adoption agencies when it identified problems with documentation.⁷¹ By failing to work closely with state agencies, the IRS missed an opportunity to connect with the impacted population in order to learn what documentation was most easily available and least burdensome and to inform them about the final documentation requirements. The IRS needs to capitalize on partnerships to provide information to taxpayers when it identifies a particular problem. By failing to engage in proactive outreach, the documentation problems continued to plague taxpayers and the IRS.

The IRS Failed Taxpayers By Not Engaging in Proactive Outreach.

The adoption tax credit is a unique refundable credit in that the eligible population is somewhat small and — if the IRS were willing to commit the time and limited resources — relatively easy to identify. Many adoptions take place through state agencies, which have direct contact with eligible taxpayers and are highly incentivized to help eligible taxpayers receive the credit. Additionally, because of the nature of adoption, countless adoption groups have direct contact with adoptive parents. By partnering with state agencies and adoption groups, the IRS would have a direct line to eligible taxpayers. The IRS could have capitalized on these connections to educate taxpayers about the credit and reached out to these same groups to help resolve problems with documentation.

Initially, the IRS's limited outreach efforts involved posting information to the IRS website.⁷² The National Taxpayer Advocate is pleased that in 2012, the IRS offered two phone forums with state agencies and adoption agencies, allowing them to call in and ask

⁶⁹ IRS, *IRS Earned Income Tax Credit (EITC) Initiatives, Addendum to the Report on Qualifying Child Residency, Certification, Filing Status, and Automated Underreporter Tests: Implementation of Alternative Approaches to Improving the Administration of EITC* (2008); IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress* (Oct. 2005).

⁷⁰ See *IRS Earned Income Tax Credit (EITC) Initiatives: Report on Qualifying Child Residency Certification, Filing Status, and Automated Underreporter Tests* 8, 14 (2008). TAS has also been working with the IRS on a three-year study related to third-party affidavits to demonstrate the residency of qualifying children during EITC audits. For more information on the 2005 pilot and a more recent TAS-IRS study on affidavits, see National Taxpayer Advocate 2011 Annual Report to Congress 304-305 (Most Serious Problem: *The IRS Should Reevaluate Earned Income Tax Credit Compliance Measures and Take Steps to Improve Both Service and Compliance*). While current audit procedures allow taxpayers to provide either official records or letters on official letterhead to document the residence of a child, this pilot program gives the taxpayer the option of using another type of documentation — a third-party affidavit. This procedure allows third-parties with knowledge of the child's residency to fill out a standardized affidavit rather than write a letter. The affidavit would be signed under penalties of perjury and list the affiant's title, agency, and contact information. The affidavit would also contain a third-party contact notification alerting the taxpayer that the IRS may contact the affiant. When questionable claims arise, the IRS can contact the affiant to verify the accuracy of the information.

⁷¹ GAO, GAO-12-98, *Adoption Tax Credit* 8 (Oct. 2011).

⁷² See Tax Tips, available at <http://www.irs.gov/uac/Tax-Tips-for-2012-1> (last visited Nov. 14, 2012).

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questions about the credit.⁷³ However, this outreach was not proactive — it placed the burden on the adoption groups to contact the IRS to receive information.⁷⁴ The IRS partners with stakeholders on an annual outreach campaign for the Earned Income Tax Credit, which kicks off with EITC Awareness Day.⁷⁵ The adoption community launched a similar effort — Adoption Tax Credit Awareness Day — to make adoptive families aware that the credit exists.⁷⁶ This would have been a perfect opportunity for the IRS to capitalize on an already planned outreach effort in order to reach impacted taxpayers.

Inability to e-File Adoption Credit Returns Causes Delay for Both Taxpayers and the IRS.

Taxpayers claiming the adoption tax credit can no longer file their returns electronically because the IRS requires paper documentation on Form 8839, *Qualified Adoption Expenses*. The prohibition on e-filing is burdensome to taxpayers who must now file paper returns. Additionally, it causes delay for both taxpayers and the IRS due to processing times and an inability to identify problematic returns more easily. E-filing capabilities for adoption credit returns would:

- Address some of the documentation problems and audit delays discussed previously;
- Require taxpayers to attach documentation to their returns before they could be submitted, reducing the number of returns submitted without documentation; and
- Allow the IRS to identify claims without supporting documentation earlier in the process, preventing delays for both taxpayers and the IRS.

The issue of electronic filing for credits involving additional documentation is not new for the IRS. The IRS faced this problem with the First-Time Homebuyer Credit (FTHBC) and TAS repeatedly raised this issue.⁷⁷ While the expanded adoption credit may have brought with it additional documentation requirements, the IRS once again failed to consider the

⁷³ IRS, *March 2012 Adoption Credit Phone Forums Questions and Answers*, available at <http://www.irs.gov/Individuals/Adoption-Credit-Phone-Forum-Questions-and-Answers> (last visited Nov. 2, 2012).

⁷⁴ For a discussion of the National Taxpayer Advocate's concerns about the IRS approach to taxpayer education, see Most Serious Problem: *The IRS Is Substantially Reducing Both the Amount and Scope of its Direct Education and Outreach to Taxpayers and Does Not Measure the Effectiveness of its Remaining Outreach Activities, Thereby Risking Increased Noncompliance*, *infra*.

⁷⁵ IRS, *On Earned Income Tax Credit Awareness Day, IRS and Partners Launch Outreach Campaign to Low- and Moderate-Income Workers*, IR-2012-11 (Jan. 27, 2012).

⁷⁶ Washington State Department of Social & Health Services, *Adoption Tax Credit Awareness Day*, available at <http://www.dshs.wa.gov/ca/fosterparents/newstaxcredit.asp> (last visited Oct. 24, 2012).

⁷⁷ National Taxpayer Advocate 2011 Annual Report to Congress 687-689 (Case Advocacy: *Policymakers Can Learn from the Implementation of the FTHBC*); National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 28-32; National Taxpayer Advocate 2010 Annual Report to Congress 15 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs*) (Case Advocacy: *TAS Assists the IRS with the Administration of the First-Time Homebuyer Credit*); National Taxpayer Advocate Fiscal Year 2011 Objectives Report to Congress 3, 37-43; National Taxpayer Advocate 2009 Annual Report to Congress 506-509; *Hearing on Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due*, *Hearing Before the S. Comm. on Finance*, 112th Cong. (statement of Nina E. Olson, National Taxpayer Advocate) (June 28, 2011); *Filing Season Update: Current IRS Issues: Hearing Before the S. Comm. on Finance*, 111th Cong. (2010) (statement of Nina E. Olson, National Taxpayer Advocate) (Apr. 15, 2010); *The National Taxpayer Advocate's 2009 Report on the Most Serious Problems Encountered by Taxpayers: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 111th Cong. (2010) (statement of Nina E. Olson, National Taxpayer Advocate) (Mar. 16, 2010).

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impact of requiring taxpayers claiming this credit to file paper returns. TAS and GAO have both noted the importance of e-filing in improving the administration of the adoption credit.⁷⁸ The Taxpayer Advocacy Panel (TAP), in its review of issues surrounding the adoption credit, recommended the IRS allow e-filing of adoption credit returns.⁷⁹

Many of the Adoption Problems Could Have Been Minimized by Considering Administrative Issues Unique to Refundable Credits.

The National Taxpayer Advocate has previously noted that compliance issues with refundable credits often stem from the design of the credits, including

- Identification of the targeted population;
- Use of data to determine eligibility;
- Use of third-party affidavits; and
- Responsiveness of the IRS in administering the credit.⁸⁰

The available data makes it clear that the IRS took none of these facts into account in administering the credit. Had the IRS worked closely with stakeholders to understand the target population, it could have designed more targeted filters. The IRS's no change rate demonstrates that the current filters have problems — problems that could have been minimized if the IRS had revised its filters once it learned they were disproportionately catching accurate claims, burdening taxpayers, and straining IRS resources.

The IRS's Implementation of the Expanded Adoption Credit Does Not Bode Well for its Implementation of the Premium Tax Credit.

The adoption credit was not the only refundable credit in the Patient Protection and Affordable Care Act. The Premium Tax Credit, which goes into effect in 2014, has the potential to be one of the largest refundable credits the IRS has had to administer. The Premium Tax Credit raises the same potential for documentation, training, and fraud problems as the adoption credit. The IRS needs to evaluate the difficulties it encountered with the adoption credit and identify potential lessons learned that can be applied to the administration of the Premium Tax Credit. If the IRS does not take the time to learn from its adoption credit experience and be thoughtful about how it administers future refundable credits, it may face problems with the Premium Tax Credit — including high examination rates — that will overwhelm IRS resources and severely burden taxpayers.

⁷⁸ National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 35-36; National Taxpayer Advocate Fiscal Year 2013 Objectives Report to Congress 46-47. GAO, GAO-12-98, *Adoption Tax Credit* (Oct.2011).

⁷⁹ Taxpayer Advocacy Panel, *Adoption Credit Processing Recommendations* (June 2012). The Taxpayer Advocacy Panel (TAP) was created in October 2002 with the expansion of the former Citizen Advocacy Panel, first established in 1998. The TAP reports to the Secretary of the Treasury, Commissioner of Internal Revenue, and the National Taxpayer Advocate with oversight and support of the program provided by the TAP Director and staff. The TAP acts as a two-way conduit between the public and IRS. The mission of the TAP is to listen to taxpayers, identify taxpayers' issues, and make suggestions for improving IRS service and customer satisfaction.

⁸⁰ National Taxpayer Advocate 2009 Annual Report to Congress 75 (Study: *Running Social Programs Through the Tax System*).

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CONCLUSION

By design, the adoption tax credit plays a critical role in helping taxpayers — particularly low and middle income taxpayers — meet the financial burden that may be involved in adopting a child. The IRS, facing a sizeable refundable credit, reacted with an enforcement strategy that was focused on stopping nearly all returns claiming the credit and subjecting a large percentage of them to an audit, instead of reaching out to stakeholders (including states) to understand the impacted taxpayer population. When problems emerged, the IRS simply continued selecting returns for audit. This approach forced taxpayers to withstand lengthy delays and the IRS to expend valuable resources with very little to show for them. As the IRS faces a new refundable credit in the form of the Premium Tax Credit, it should study and learn from its mistakes to avoid repeating them again, when there will be even more at stake.

The National Taxpayer Advocate preliminarily recommends that the IRS:

1. Provide examples of acceptable adoption credit documentation for taxpayers.
2. Develop a proactive outreach and education strategy that involves working with state adoption agencies or similar agencies to better understand the demographics and needs of the affected taxpayer population and address documentation issues.
3. In consultation with the National Taxpayer Advocate and external stakeholders, develop a third-party affidavit form for verification of a child's special needs status.
4. Allow e-filing of adoption tax credit returns that include substantiation in an electronic format.
5. Consider the factors for refundable credits laid out by the National Taxpayer Advocate when moving forward with the administration of the Premium Tax Credit.
6. Study the administration of the adoption credit to identify lessons that can be applied to the administration of other refundable credits, including the Premium Tax Credit.

IRS COMMENTS

The IRS modeled the adoption credit program on processes and procedures in place for other refundable credits and built upon lessons learned from our experience in administering those programs. Our programs for refundable credits emphasize outreach to taxpayers and supporting stakeholders as well as overall compliance with the tax laws. The IRS is committed to ensuring adoptive parents receive the benefits to which they are entitled, and that they understand and fulfill their tax obligations.

The IRS implemented the adoption credit program with an approach that balanced the objective of paying legitimate credits in a timely manner with that of ensuring that claims were accurate. Our experiences and lessons learned from other refundable credits taught us that high dollar credits have high risk and the potential for fraud. We must ensure

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delivery of the credit to those entitled while protecting the government's interest in minimizing exposure to fraud.

As noted in the Most Serious Problem, the adoption credit environment and rules are varied and complex, making the credit challenging to administer. There are different rules for special needs, foreign, and domestic adoption options, nonqualification of expenses paid for by federal, state or local adoption grant programs, and carryforward provisions. Centralized third-party data does not exist for the IRS to validate all claims.

The IRS evaluated the risk associated with this high-dollar credit and decided to require taxpayers to attach documentation to their returns. We implemented new procedures within the IRS to review the documentation and quickly process the returns, our goal being to avoid refund delays for taxpayers who attached requested documents. We developed examination filters, based on historical filing data, characteristics of taxpayers claiming the adoption credit in the past, other research data we gathered, and lessons learned from other refundable credits. We used that information to develop our filters and adjusted as needed for new information and experience.

The IRS held monthly cross-functional meetings that included TAS representatives to review implementation of the strategy, to immediately address issues, to streamline internal processes and to cultivate servicewide best practices. This involved continual monitoring and adjustment of our examination filters. The IRS analyzed the data collected and compiled lessons learned from the first year of the adoption credit program. As a result, changes were made to examination filtering, selection processes and outreach based on a reexamination of associated risk through data captured. The changes made improved and reduced audit selections and reduced taxpayer burden.

Recognizing the taxpayer impact of holding large-dollar refunds, the IRS placed additional emphasis on processing adoption credit audits in an expeditious manner. Due to the upfront documentation requirement, the processes we put in place and the priority we assigned these cases, the cycle time for closed examination adoption cases has been significantly less than other audits. We believe the lack of fraud identified with this credit was in large part due to the documentation requirements that were implemented.

In FY 2012, we found errors in 44 percent of the returns we examined and closed, protecting revenue of almost \$135.5 million. During both FY 2011 and FY 2012, we protected almost \$164 million on cases closed in our examination functions. Examinations on TY (TY) 2011 returns continue, and we expect that the overall change rate and dollars assessed will continue to increase as the cases close.

As part of our effort to help adopting taxpayers understand and fulfill their tax obligations, we emphasized information on internal and external websites regarding the documentation requirement as well as the examination process. We emphasized information such as documents needed and potential consequences of not including documentation, which

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could cause refund delays and subject returns to audits. We included information on expected timing, including average examination process time as well as post examination refund issuance.

In addition to the compliance part of our strategy around the adoption credit, the IRS implemented an equally important strategic communication plan for outreach. The communication strategy included collaboration with external stakeholders and extensive training for our tax examiners. The IRS coordinated with various state agencies to identify third party data that could be used to verify legitimate domestic and special needs claims. Our communication plan included outreach activities and products and guidance. We updated forms and publications, posted information on our internal and external websites, issued public service announcements, communicated with the professional preparer community and collaborated with software developers. Our goal was to ensure taxpayers, preparers, adoption organizations, and software developers who supported the taxpayers in different roles, understood the new adoption credit requirements and procedures.

When a high percentage of taxpayers did not attach required documents, the IRS immediately took action with a new communications effort. The IRS issued a Tax Tip, email blasts to adoption organizations, e-News for Tax Professionals, and a YouTube video, all of which focused on the new documentation requirement. The IRS reached out to software developers and large tax preparation firms to notify them of the documentation problem and to request their assistance. As a result, these partners improved software and issued guidance to preparers. These efforts resulted in a 40 percent improvement in the percentage of returns filed with no documentation from the 2011 to 2012 filing season.

In FY2012, based on stakeholder feedback, we expanded and further improved our outreach. In addition to making standard yearly updates for amounts and limitations, we (i) revised the Instructions and Form 8839 to include statements at the top and bottom of the form to direct taxpayers to attach required documents; (ii) developed a Tax Talk Today webcast for preparers which included information on steps preparers could take to assure eligible taxpayers receive the adoption credit; (iii) recognized National Adoption Credit Month with an IRS News Tweet with a link to irs.gov; (iv) held two Webinars with various state and private adoption agencies; and (v) posted an If/Then Chart to simplify documentation requirements for the different types of adoptions.

The IRS agrees it is important for taxpayers to understand what documentation is acceptable. However, the IRS believes while posting examples of acceptable documentation may help some taxpayers, we remain concerned that other individuals could use that information to perfect fictitious documents that they could be used to make fraudulent claims for the adoption credit. The IRS used other outreach, as explained above, to communicate with taxpayers about documentation.

The IRS agrees that, when implementing any new credit, we should use a proactive approach. We did this with the expanded adoption credit. The IRS used historical research

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data and lessons learned from other refundable credits to develop and implement a strategic communication plan. This plan included extensive communication and outreach beginning in September 2010 and continuing through the present. The IRS proactively sought and established relationships with various state adoption agencies, advocacy groups and tax preparers to learn more about this unique population. This allowed us to develop key messages and target audiences as appropriate for our adoption credit communications. This process also improved our knowledge of related adoption issues. Very importantly, this approach was established early and relied on continued open lines of communication with stakeholders who communicated issues on which we immediately took action.

The IRS considered the feasibility of implementing a third party affidavit form for verification of a child's special need status and made a business decision not to do so. The states and/or counties provide special needs documentation during or after the adoption process to adoptive parents. The IRS decided to minimize burden on taxpayers and to avoid undue delays in issuing refunds by accepting the documents already available to adoptive parents. We also considered the burden to the third parties in many levels of many government agencies who would be completing the affidavits and the challenges to those agencies and to the IRS in educating the parties involved for a time-limited potential need.

The IRS investigated electronic filing and possible attachment of documentation to electronic returns for TY 2011. However, based on the expected significant decrease in the volume of adoption credit returns in 2011 (which occurred), limited e-filing capabilities, and equipment necessary, we were unable to pursue an electronic option for TY 2011. The IRS is not requiring documentation to be attached to 2012 returns when the credit becomes nonrefundable (however, as with other claims, taxpayers must maintain proof that their claim is accurate). Unfortunately, we are unable to re-implement electronic filing for the upcoming filing season, but expect to be able to allow electronic filing for future years. We will ensure that our outreach efforts to preparers and the adoption community would clearly communicate this information.

With respect to the recommendations related to the Premium Tax Credit, the IRS will consider the input of the National Taxpayer Advocate in our administration of the Premium Tax Credit while we build upon our knowledge and recent experience in implementing and administering other refundable tax credits.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS is committed to ensuring adoptive parents receive the benefits to which they are entitled. The IRS's commitment to emphasizing outreach and education and partnering with advocacy groups to understand the target population is encouraging. In addition, the IRS's efforts to share information through monthly cross-functional meetings — of which TAS was a participant — allowed a proactive approach to some compliance issues as they arose.

The rules associated with the adoption credit are complex and varied, posing a compliance challenge for the IRS. However, it is clear that the IRS failed to take into account the specific characteristics of the target population — particularly low and middle income taxpayers — when designing its examination filters. While the IRS states it took efforts to continually adjust the system, 90 percent of returns claiming the refundable adoption credit during the 2012 filing season tripped filters that select returns for examination.⁸¹ Income-based filters were responsible for over one-third of these additional reviews.⁸² The IRS clearly did not take into account the demographics of the impacted taxpayers as it designed — and adjusted — its filters. And although the IRS states that it conducted extensive research about the credit, it clearly did not read or review either the congressional record laying out Congress' focus on low and middle income families or its concerns about IRS unduly burdening credit applicants. Nor does it appear that the IRS reviewed or heeded the National Taxpayer Advocate's comprehensive analysis of and recommendations for effective administration of social programs in the Internal Revenue Code.⁸³

In its response, the IRS states that "In FY 2012, we found errors in 44 percent of the returns we examined and closed, protecting revenue of almost \$135.5 million." *This means that in 56 percent of its adoption credit audits, the IRS found no errors.* This no-change rate is among the highest the National Taxpayer Advocate has ever seen since she was appointed to this position. For the IRS to say, with a straight face, that this is a positive result of any audit strategy makes a mockery of effective tax administration. It also signals that the IRS continues to underestimate or ignore the true burden it placed on taxpayers who are legitimately claiming a tax benefit to which they are entitled and sorely need.

Despite the fact that taxpayers are not required to attach documentation for 2012 adoption credit claims, they still cannot electronically file these claims. The current approach causes significant additional burden on both taxpayers and the IRS. The National Taxpayer Advocate is hopeful that the IRS will change this policy for future filing seasons, as the IRS comments indicate.

⁸¹ IRS Production Report, Adoption Credit Compliance Filters Report Through Cycle 2012-38 (through Sept. 14, 2012).

⁸² *Id.* Includes late-filed 2010 returns as well as 2011 returns. A single claim can trip more than one filter.

⁸³ National Taxpayer Advocate 2009 Annual Report to Congress 75 (Study: *Running Social Programs Through the Tax System*).

The National Taxpayer Advocate is disappointed that fear of possible fraudulent claims has prevented the IRS from providing sample documentation that could have eased the process of claiming the credit for taxpayers and prevented some costly, time-consuming documentation problems for the IRS. Sample documentation, on its own, is not enough to allow a fraudulent claim. While the IRS must take action to prevent fraudulent claims, it cannot allow potential fraud to also prevent eligible taxpayers from receiving much-needed guidance.

The National Taxpayer Advocate is pleased that the IRS recognizes the critical role of proactive outreach and education in ensuring the success of a refundable credit targeted to a specific group of taxpayers. We hope the IRS's efforts to develop relationships with state adoption agencies and advocacy groups in order to understand the population eligible for the adoption credit will encourage the IRS to reach out to similar groups in the future. We also are encouraged that the IRS engaged in proactive outreach when it identified documentation issues with a significant number of adoption credit claims. However, the IRS should not rely on its standard outreach procedures of working through practitioners and software developers. It must capitalize on the ability of various advocacy groups to communicate with the target population.

While the National Taxpayer Advocate is pleased that the IRS considered the use of a third-party affidavit, we are disappointed by the decision not to use this tool. The affidavit would not impose a burden on taxpayers or third parties — it is designed to be an option that taxpayers can use to meet the IRS's documentation requirements with as little burden as possible. The National Taxpayer Advocate urges the IRS to reconsider its position on the use of the third-party affidavit.

The adoption tax credit is just the first refundable credit to emerge from the Affordable Care Act. While the IRS claims its approach to the adoption credit emphasized outreach and ensuring that taxpayers received the tax credits to which they were entitled, the data indicate that this was not always the case. The National Taxpayer Advocate commits to working collaboratively with the IRS as it develops procedures to administer the Premium Tax Credit to ensure that the IRS takes a taxpayer-focused approach and does not make the same mistakes it made with the adoption credit. We encourage the IRS to consider the factors for refundable credits that we have previously outlined as it moved forward with administering the Premium Tax Credit.

Recommendations

The National Taxpayer Advocate recommends the IRS take the following actions:

1. Ensure that any examination filters take into account the congressionally-intended demographics of the affected taxpayer population and are continually monitored and updated if data demonstrate that they are catching more taxpayers than appropriate.
2. Provide examples of acceptable adoption credit documentation for taxpayers.
3. In consultation with the National Taxpayer Advocate and external stakeholders, develop a third-party affidavit form for verification of a child's special needs status.
4. Allow e-filing of adoption tax credit returns that include substantiation in an electronic format.
5. Consider the factors for refundable credits laid out by the National Taxpayer Advocate when moving forward with the administration of the Premium Tax Credit.
6. Study the administration of the adoption credit to identify lessons that can be applied to the administration of other refundable credits, including the Premium Tax Credit.