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Tax Benefits for Families: Adoption

Christine Scott, Domestic Social Policy Division

September 17, 2008

Abstract. In the 110th Congress, legislation has been introduced (H.R. 273, H.R. 471, S. 561, and S. 3079) that would repeal the EGTRRA sunset provision as it relates to the adoption tax provisions. H.R. 1074, H.R. 3192, and S. 2407, would increase the maximum qualified expenses from \$10,000 to \$15,000 (with an inflation adjustment) and make the adoption tax credit refundable. H.R. 4313 would provide an additional \$2,000 of tax credit for adopting an older child. This report outlines the tax benefits for adoption, examines the associated policy issues, and provides a legislative history of the tax provisions for adoption.

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Tax Benefits for Families: Adoption

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January 16, 2009

<http://wikileaks.org/wiki/CRS-RL33633>

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Summary

The federal government provides assistance for the adoption of children through federal grants to states and through the tax code. Although federal assistance programs for adoption focus primarily on children adopted out of foster care, federal adoption tax provisions are available for all adoptions (except for adoptions of stepchildren).

Congress created federal tax assistance for adoption by enacting the Small Business and Job Protection Act of 1996 (P.L. 104-188). The act added tax incentives for adoption to the existing federal adoption assistance grant programs by creating a tax credit and an income tax exclusion of up to \$5,000 per adoption and \$6,000 per adoption of a special needs child. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) increased qualified expenses for the credit (and the income tax exclusion) to \$10,000 (indexed for inflation), but with a sunset period. Beginning in 2011, the prior law limits of \$5,000 and \$6,000 will become effective again.

The tax credit and the income tax exclusion significantly limit who may benefit from the tax provisions. Both provisions are subject to a phase-out rule (which creates an income cap), and the tax credit is nonrefundable (which creates a minimum income level for using the credit). These provisions limit the number of taxpayers who benefit from the credit. As a result, in tax year 2006, very few families with an adjusted gross income of less than \$30,000, or with an adjusted gross income of \$200,000 or more, claimed the credit. In tax year 2006, approximately 93,400 tax returns, or .07% of all tax returns, included a claim for the adoption tax credit, with a total credit value claimed of \$301.9 million.

Policy issues associated with the tax provisions are the limited availability of the credit resulting from the phase-out rule and nonrefundability of the credit, more generous provisions for domestic adoptions and for adoptions of special needs children, and whether the tax system is the most efficient means of providing federal assistance for adoption.

In the 110th Congress, legislation was introduced (H.R. 273, H.R. 471, H.R. 3758, S. 561, and S. 3079) that would have repealed the EGTRRA sunset provision as it relates to the adoption tax provisions. H.R. 1074, H.R. 3192, H.R. 7091, and S. 2407, would have increased the maximum qualified expenses from \$10,000 to \$15,000 (with an inflation adjustment) and made the adoption tax credit refundable. H.R. 4313 would have provided an additional \$2,000 of tax credit for adopting an older child. This report outlines the tax benefits for adoption, examines the associated policy issues, and provides a legislative history of the tax provisions for adoption. It will be updated as warranted by legislative activity.

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States have paramount responsibility in setting policy to govern the process of child adoption. Nonetheless, the federal government plays a significant—though indirect—role in supporting adoption through grants to states that provide both one-time and ongoing subsidies to parents of adoptive children with special needs and through tax benefits that help offset the costs of adopting a child. This report focuses primarily on the latter—the federal adoption tax credit and income tax exclusion for employer-provided adoption assistance.

Scope of Adoption

There are several types of adoption, including domestic public agency adoption, domestic private adoption, and intercountry adoption. With regard to each of these types of adoption, the Department of Health and Human Services (HHS) collects data on children adopted with the involvement of state child welfare agencies, and the Department of State records the number of intercountry adoptions through its visa reporting system. However, statistics on private adoptions are the least reliable or consistent, because private agencies and individuals who facilitate independent adoptions are not required to report data to either state or federal agencies.

The most recent data on all types of adoption, collected by the National Center for State Courts (NCSC), indicate that an estimated 127,000 children were adopted in 2001. This is approximately the same estimated number of adoptions as in 1992 and somewhat higher than the estimated 118,000 adoptions in 1987.¹ According to NCSC data, of adoptions in 2001, an estimated 46% were private (including tribal and kinship, such as stepparent), 39% were intercountry, and 15% were public agency adoptions. However, these percentages differ greatly from 1992, when an estimated 77% of adoptions were private, 5% were intercountry, and 18% were public agency adoptions.

The tax provisions described in this report cover all types of adoption, except for adoptions by stepparents. According to data for 1992 (the most recent available), the majority of private adoptions (or 42% of total adoptions) were by stepparents.²

Domestic Public Agency Adoptions

Children in state foster care are typically placed in either foster family homes, relative foster homes, group homes, or institutional settings such as hospitals or residential treatment centers. On the last day of FY2006, approximately 510,000 children were in foster care and 129,000 were “waiting” to be adopted. (Foster children waiting to be adopted include those who have a permanency goal of adoption and/or those whose parental rights have been terminated.) During FY2006, 51,000 children were adopted with the involvement of state child welfare agencies.

¹ Department of Health and Human Services (HHS), Administration for Children and Families, Children’s Bureau, Child Welfare Information Gateway, *How Many Children Were Adopted in 2000 and 2001?* (hereafter cited as Child Welfare Information Gateway, *How Many Children?*). To obtain these data for inclusion in the cited estimate for the total number of adoptions, the National Center for State Courts relied on various sources, including direct contacts with state courts, public and private agencies, and state bureaus of vital records. The Child Welfare Information Gateway is available at <http://www.childwelfare.gov/>.

² Child Welfare Information Gateway, *How Many Children?* Adoption by a stepparent may be of any kind, but is assumed to be domestic private adoption in most cases.

These numbers reflect a steady level over the past five years among children in foster care, those awaiting adoption, and the number of children adopted in a given year.³

Domestic Private Adoptions

Domestic private adoptions are facilitated by state-licensed private agencies or through independent agreements in which an individual arranges for another party to adopt his or her child.⁴ Like all adoptions, private adoptions are finalized by state or tribal courts, but data on these adoptions are not systematically collected or reported. Therefore, national data on domestic private adoptions are the least reliable or consistent. The most recent effort to count domestic private adoptions was in 2001 when, as noted earlier, the National Center on State Courts estimated them at 58,600 (or 46% of the estimated 127,000 adoptions of all kinds) adoptions. The comparable estimate for FY1992 was 77% of the total number of adoptions (also estimated at 127,000 for that year), or 97,700 adoptions.

Intercountry Adoptions

Intercountry (also called foreign or international) adoptions are adoptions of non-citizen or resident children by families who are citizens or legal residents of the United States.⁵ In FY2007, the Department of State reported issuing 19,613 immigrant visas to orphans entering the United States. Issuance of such a visa is a prerequisite for intercountry adoption by a U.S. citizen, and the number of such visas is considered a good proxy for the number of such adoptions. The comparable number of visas in FY2000 was 17,718; in FY1990, the number of such visas issued was 7,093.⁶

Overview of the Tax Credit and Income Tax Exclusion

Adoption costs can exceed \$40,000, depending on the type of adoption, with the following ranges:⁷

- Domestic public agency adoptions: \$0 to \$2,500.
- Domestic private adoptions: \$5,000 to \$40,000 (or more).

³ U.S. Department of Health and Human Services, Administration for Children and Families, Children's Bureau, Trends in Foster Care and Adoption, FY2000-FY2005 (based on AFCARS data submitted by states as of August 2006), available at http://www.acf.dhhs.gov/programs/cb/stats_research/afcars/trends.htm.

⁴ Evan B. Donaldson Adoption Institute, *Adoption Facts* (2006), see <http://adoptioninstitute.org/research/adoptionfacts.php> (hereafter referred to as The Adoption Institute: *Adoption Facts*).

⁵ For more information on intercountry adoptions, see CRS Report RL30979, *Intercountry Adoption Act of 2000 and International Adoptions*, by Douglas Reid Weimer.

⁶ United States Department of State, Bureau of Consular Affairs, Orphan Visa Statistics, *Immigrant Visas Issued to Orphans Coming to the United States*, see <http://travel.state.gov/pdf/FY07AnnualReportTableVIII.pdf>.

⁷ Child Welfare Information Gateway, *Costs of Adopting: A Factsheet for Families*, 2004, available at http://www.childwelfare.gov/pubs/s_cost/index.cfm.

- Intercountry adoptions: \$7,000 to \$30,000 (or more).

The federal adoption tax credit and income tax exclusion (for employer-provided adoption expenses) are intended to help offset some of the costs of adoption for taxpayers.⁸

Both the credit and the income tax exclusion are subject to the same phaseout (or income limitation) and the same maximum qualified expenses that can be claimed per adoption. Both provisions use the same definitions of qualified expenses, eligible child and special needs child, and both have the same special rules for intercountry adoptions.

The Adoption Tax Credit

The Adoption Tax Credit is available to taxpayers who have either initiated or completed the adoption process.⁹ Unlike many other tax credits, the adoption tax credit has a 100% credit rate—the amount of the credit is the same as the amount of qualified expenses. The dollar limit for qualified expenses is adjusted annually for inflation.¹⁰ In tax year 2008, the dollar limit for qualified expenses is \$11,650.

The most recent public data available on the use of the adoption tax credit by the type of adoption are for tax year 2004. In tax year 2004, taxpayers claimed adoption tax benefits for the adoption of 12,432 children with special needs, or about 18% of all adoptions for which tax benefits were claimed. In contrast, in that same year, taxpayers adopting internationally claimed some part of the tax credit for 29,296 adoptions, representing about 33.7% of the adoptions for which tax benefits were claimed.¹¹ In contrast, in tax year 1998, tax benefits were claimed for the adoption of 50,400 individuals including 4,700 special needs children, and 14,300 intercountry adoptions. Although the total number of adoptions for which tax benefits are claimed has increased, the growth for special needs children is significant.

Qualifying Expenses

A taxpayer can claim only expenses that are necessary and reasonable and directly related to the adoption of an eligible child.¹² The term “eligible child” refers to children under age 18 and to individuals who are physically or mentally incapable of taking care of themselves.¹³ Qualified

⁸ For help with the tax terms used in this report, please see CRS Report RL30110, *Federal Individual Income Tax Terms: An Explanation*, by Pamela Jackson, or Internal Revenue Service (IRS) Publication 17, *Your Federal Income Tax*.

⁹ A taxpayer can incur qualified adoption expenses throughout, and even after completing, the process to adopt a child. One example of an expense incurred at the beginning of the process is adoption fees. During the process, the taxpayer may incur travel expenses as part of the adoption process, and after completion of the adoption process, the taxpayer may incur qualified expenses for the final legal fees.

¹⁰ In statute, the limitation is \$10,000 adjusted for inflation each year beginning with tax year 2003.

¹¹ Department of the Treasury, *Report to the Congress on Tax Benefits for Adoption*, October 2000, pp. 2-3, and *Federal Income Tax Benefits for Adoption, Use by Taxpayers, 1999-2005*, June p. 44. The data in the report on the adoption tax credit reflect the credit taken that tax year. Taxpayers may not be able to use the full amount of the adoption tax credit in the tax year in which they incur qualified adoption expenses. They can carryover any unused adoption tax credit to future tax years (for up to five tax years).

¹² Internal Revenue Code (IRC) § 23(d)(1)(A).

¹³ IRC § 23(d)(2).

expenses do not include those that violate federal or state law, are incurred in carrying out any surrogate parenting agreement, or are for the adoption of a child who is the child of the taxpayer's spouse (i.e., a stepchild).¹⁴

For domestic adoptions, taxpayers may claim the adoption tax credit in the tax year that they incur the qualifying expense, without regard to the status of the adoption. This means that even if an adoption is never finalized, the taxpayer may claim the adoption tax credit for the qualified expenses associated with the adoption. For intercountry adoptions, the adoption must be finalized before the taxpayer can claim the adoption tax credit for any qualifying expenses. Specific types of expenses eligible for the credit are not listed in the Internal Revenue Code (IRC). **Table 1** shows examples of qualified expenses provided by Internal Revenue Service (IRS) publications.

Table 1. Examples of Qualifying and Non-Qualifying Expenses

| Qualifying Expenses | Non-Qualifying Expenses |
|---|--|
| —court costs | —expenses already covered by assistance through state, federal, employer or other programs |
| —attorney fees | —expenses that violate state or federal law |
| —adoption fees | —expenses incurred for an adoption carried by a surrogate |
| —travel expenses | —expenses incurred for adopting a spouse's child |
| —re-adoption expenses in the case of intercountry (foreign) adoptions | —expenses paid before 1997 |
| —other costs directly related to the adoption | |

Source: Internal Revenue Service (IRS) Publication 968 (for tax year 2004 returns).

Note: These lists are not exhaustive but are intended to illustrate what are considered qualifying expenses and non-qualifying expenses.

Special Rules for Special Needs Children

Beginning with tax year 2003,¹⁵ a taxpayer claiming the credit for the adoption of a special needs child is assumed to have incurred the maximum amount of qualifying expenses and may claim the full credit.¹⁶ Many children adopted from the public child welfare system meet the definition of special needs for the adoption tax credit. A child is defined as a special needs child if the child's state of residence determines that

- the child cannot, or should not, be returned to the home of his or her birth parents;
- there is a specific factor or condition which leads to the reasonable conclusion that the child will not be adopted without assistance provided to the adoptive parents;
- and the child is a citizen or legal resident of the United States.

¹⁴ IRC § 23(d)(1)(B) and IRC § 23(d)(1)(C).

¹⁵ Prior to tax year 2003, a taxpayer claiming the adoption tax credit (or using the income tax exclusion) for the adoption of a special needs child had to document the qualifying expenses.

¹⁶ IRC § 23(d)(3)

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Examples of specific factors (or conditions) that may be considered in determining whether a child is a special needs child include ethnicity; minority status; age; status as part of a sibling group; mental, emotional or physical handicap; and other medical conditions.¹⁷ The definition of “special needs” for the adoption tax credit matches the definition provided in Section 473 (Title IV-E) of the Social Security Act for the federal Adoption Assistance Program.¹⁸

Special Rules for Intercountry Adoptions

For purposes of the tax code, a child must be a legal resident or citizen to qualify as a special needs child; therefore, no intercountry adoption meets the tax code’s definition of special needs.¹⁹ Although a taxpayer may not claim a total adoption tax credit of more than \$11,650 in tax year 2008 for any single adoption, the taxpayer may claim the adoption tax credit for a single adoption in more than one tax year, depending on when the adoption expenses are paid and whether the adoption is domestic or intercountry. For a domestic adoption, the qualifying expenses may be claimed for the adoption tax credit prior to and during the adoption process, even if the adoption is not finalized; for an intercountry adoption, the adoption *must* be finalized before a taxpayer can claim the credit for the adoption expenses.²⁰ Therefore, a taxpayer adopting a foreign child may only claim the credit beginning in the tax year in which the adoption is finalized. **Table 2** shows the relationship between the tax year in which expenses are paid and the tax year when those expenses are eligible for the adoption tax credit, based on the type of adoption.

**Table 2. When Qualified Expenses Are Eligible:
Domestic and Intercountry Adoptions**

| When the Qualified Expenses Are Incurred | When Taxpayer May Claim Expenses | |
|--|--|--|
| | Domestic Adoptions | Intercountry Adoptions |
| Tax years before the tax year in which the adoption is finalized | Tax year in which expenses are incurred (or later tax years) | Tax year in which the adoption is finalized (or later tax years) |
| Tax year in which the adoption is finalized | Tax year in which the adoption is finalized (or later tax years) | Tax year in which the adoption is finalized (or later tax years) |
| Tax years after the tax year in which the adoption is finalized | Tax year in which expenses are incurred (or later tax years) | Tax year in which the expenses are incurred (or later tax years) |

Source: Information taken from IRS Publication 968 (for tax year 2004 returns).

¹⁷ Ibid.

¹⁸ For more information on federal adoption assistance programs, see CRS Report RL31242, *Child Welfare: Federal Program Requirements for States*, by Emilie Stoltzfus.

¹⁹ IRC § 23(d)(2)(C)

²⁰ IRC § 23(e).

Limitations

In addition to the maximum amount for qualified expenses, two other significant limitations are related to the credit. The first is the phaseout of the credit, or maximum income limitation. The full credit can only be claimed by families with an adjusted gross income (AGI)²¹ equal to or less than \$174,730 in tax year 2008.²² For taxpayers with incomes above this threshold amount, their credit is reduced by the ratio of their income above the threshold to \$40,000. For example, a taxpayer with an AGI of \$180,000 would have their credit reduced by 13.2% (calculated as \$180,000 - \$174,730, or \$5,270 divided by \$40,000, equals 13.2%). For taxpayers with an AGI \$40,000 or more above the threshold,²³ the credit is reduced to zero (\$0).

The second limitation is that the credit is nonrefundable, and a nonrefundable tax credit can only offset tax liability.²⁴ For the adoption tax credit, the actual amount of the credit that may be taken is based on tax liability remaining after (almost all) other nonrefundable tax credits have been applied—the foreign tax credit, credit for child and dependant care expenses, credit for the elderly and disabled, education credits, retirement savings contribution credit, and the child tax credit.²⁵ Therefore, taxpayers with a tax liability that is significantly lower than their qualified adoption expenses (after the other nonrefundable tax credits) receive only a limited benefit from the tax credit. If the qualified expenses exceed the taxpayer’s tax liability, the tax liability will be reduced to zero, but the taxpayer will not receive a refund. The lower the taxpayer’s tax liability, the lower the benefit from the credit. There is, however, a carryover provision that allows a taxpayer to carry the credit forward for up to five years.²⁶

Claiming the Credit

To claim the adoption tax credit, a taxpayer must fill out IRS Form 8839.²⁷ Depending on the taxpayer’s marital status, the filing requirements may vary. Generally, a married couple must file a joint tax return to claim the adoption tax credit.²⁸ If two taxpayers (not married to each other) wish to claim the adoption tax credit, they may split the qualified expenses for the adoption tax

²¹ Adjusted gross income is total taxable income after statutory adjustments. Total taxable income does not include income that is exempt from income taxes (such as veterans benefits). Statutory adjustments reduce taxable income before exemptions and any standard or itemized deductions. Examples of statutory adjustments are Health Savings Accounts, IRA deductions, and alimony paid. The limitation is based on adjusted gross income without regard to IRC Sections 911, 931, or 933.

²² IRC § 23(b)(2)(A). The income limitation is \$150,000 adjusted for inflation; therefore, the income limit in tax year 2008 is \$174,730.

²³ Taxpayers with an income of \$214,730 or more in tax year 2008.

²⁴ A non-refundable tax credit is a tax credit that cannot exceed a taxpayer’s tax liability. Any credit amount “left over” (more than the taxpayer’s tax liability) may be (depending on the tax credit) carried over and used in a future tax year. With a refundable tax credit, such as the Earned Income Tax Credit, the taxpayer receives a tax refund for the amount of the tax credit in excess of tax liability.

²⁵ IRC § 23(b)(4).

²⁶ IRC Title 26, Section 23 (c).

²⁷ IRS Instructions for Form 8839 (for tax year 2005).

²⁸ Ibid. If a married person has been living apart from his or her spouse for more than six months of the tax year, the child to be adopted has lived with the person for more than six months of the tax year, and the person has paid more than one-half of the adoption costs and the cost of the home in which the person and the child reside, the married person may claim the adoption tax credit when filing a married filing separate tax return.

credit (and therefore the adoption tax credit) by mutual agreement.²⁹ However, the total of qualified expenses (and adoption tax credit) cannot exceed the maximum allowed under law (\$11,650 in tax year 2008). Taxpayers must include the tax identification number (Social Security number) of the child they are adopting.³⁰ Finally, taxpayers must keep all receipts and records of expenses for reporting purposes.³¹

Income Tax Exclusion for Employer Adoption Assistance

Generally, the income tax exclusion for employer adoption assistance follows many of the same rules, applications, and limitations as the adoption tax credit.³² The maximum amount of qualified expenses that can be claimed is subject to the same dollar limitation as the tax credit.³³ A taxpayer's eligibility for the income tax exclusion is also subject to the same income limitation (or phaseout) as the adoption credit.³⁴ The income tax exclusion for employer-provided adoption assistance follows the same definitions of special needs children, qualified expenses, and eligible children. The special rules for intercountry adoptions and filing requirements of the adoption tax credit also apply to the income tax exclusion.³⁵ Individuals can use both the adoption tax credit and the income tax exclusion (if both are available to them), but cannot claim the same expenses for both tax provisions.³⁶ Employer-provided adoption assistance must be provided through a separate written plan for an adoption assistance program, which is generally available to all employees. However, employers are restricted from offering the adoption assistance program to certain high-earning employees.³⁷

Unlike the adoption tax credit, employer adoption assistance programs act as income tax exclusions. This means that an employee who has qualifying expenses covered through an employer adoption assistance program (expenses paid for by the employer or through a reimbursement program funded by the employer, employee, or both parties) does not have to include the value of the covered adoption expenses as income for federal income taxes.³⁸ Employer adoption assistance programs are a separate employee benefit and are provided by direct payment of eligible expenses by the employer or the reimbursement of eligible expenses through an account (usually administered by a third party) funded by the employee, employer, or

²⁹ Ibid.

³⁰ Ibid.

³¹ Ibid.

³² An income tax exclusion is a form of income that is not subject to taxation. An income tax exclusion is normally not reported for tax purposes (i.e., federal income taxes and/or employment taxes). Examples of an income tax exclusion are 401(k) contributions and fringe benefits, which are not included as income for federal income taxes and/or employment taxes (Social Security and Medicare taxes) on a person's wage statement or W-2 form. They may, however, be reported separately on the form for information purposes.

³³ IRC § 137(b)(1)

³⁴ IRC § 137(b)(2)

³⁵ IRC § 137(e)

³⁶ IRC § 23(3)(A)

³⁷ IRC § 137(c), and IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*. During the year, no more than 5% of all payments made by the adoption program can be for shareholders or owners (or their spouses or dependents). A shareholder or owner is defined as someone who owns 5% or more of the stock, capital, or profit of the business (on any day of the year).

³⁸ IRC §137(a)(1)

both.³⁹ Employers may include an adoption assistance program based on reimbursement as part of a cafeteria plan for employee benefits, and reduce an employee's salary to pay for the benefit. Companies may offer informational and referral benefits, direct payment or reimbursement of eligible expenses, paid leave benefits, or a combination of benefits for adoption.⁴⁰

According to the Department of Health and Human Services, a Hewitt Associates study found that 39% of major U.S. companies offered adoption assistance as an employee benefit.⁴¹ Employers sampled by Hewitt offered from \$1,500 to \$15,000, with an average of \$3,879 in reimbursement of adoption expenses.⁴² Because an employer has discretion in the amount and type of assistance offered for adoption, the income tax exclusion for employer-provided adoption assistance may be more limited than the adoption tax credit in the types of eligible adoption assistance.

Although employer-provided adoption assistance is excluded from federal income taxes, unlike other flexible benefits such as child care, *it is still subject to Social Security and Medicare taxes.*

Policy Issues

Several policy issues are associated with the federal adoption tax provisions, including the limitations on the credit (the phaseout and nonrefundability), the rules for special needs children and intercountry adoptions, the sunset of the EGTRRA changes, and whether the tax provisions are the best way to provide adoption assistance.

Phaseout (Income Limitation)

To claim the full value of the adoption tax credit, a taxpayer must have a tax liability after other nonrefundable tax credits that is equal to or greater than the maximum amount of qualified expenses for the tax credit. For example, for a childless married couple adopting a child in tax year 2008, the full tax credit and exclusion would be claimed in tax year 2008, only if the taxpayer (the married couple) has an adjusted gross income (AGI) between approximately \$90,000 and \$174,730.⁴³ If the taxpayer has an income outside this range, the taxpayer will have a reduced credit or no credit in the tax year 2008, but in some cases may be able to claim the balance of the credit in future tax years (in up to 5 future tax years).

Nonrefundability

The adoption tax credit is available to families at all incomes below the level at which the adoption tax credit is completely phased out (\$214,730 in tax year 2008). In practice, because the

³⁹ *Los Angeles Times*, Business: "Personal Finance; Aid is Available to Help Ease Adoption Burden," p. C2, July 31, 2005 (hereinafter referred to as *Personal Finance; Aid is Available*).

⁴⁰ Department of Health and Human Services, Administration for Children and Families, Children's Bureau, NAIC, *Employer-Provided Adoption Benefits* (2004), available at http://www.childwelfare.gov/pubs/f_benefi.cfm.

⁴¹ *Ibid.*

⁴² *Ibid.*

⁴³ Calculations by the Congressional Research Service (CRS) using SysTTIM (System for Tax, Transfer and Income Modeling), a case simulation model.

adoption tax credit only works to offset tax liability after other nonrefundable tax credits (in other words, it is not refundable), taxpayers whose tax liability (after other nonrefundable tax credit) is lower than their qualified adoption expenses will receive a reduced adoption tax credit or no adoption tax credit. The interaction of the adoption tax credit with the other nonrefundable credits is significant because when a taxpayer (with qualified adoption expenses) adopts a child, the taxpayer becomes eligible for a \$1,000 child tax credit (for the adopted child). The child tax credit reduces tax liability *before* the adoption tax credit.

For example, in tax year 2008 a married couple adopts a child and has qualified adoption expenses (in tax year 2008) of \$15,000. If the couple's income is \$50,000, their income tax liability before credits is \$4,657. After the nonrefundable child credit of \$1,000, their remaining tax liability is \$3,657. This is the maximum adoption tax credit the couple can claim, with the remaining credit (\$8,082) carried over to future tax years.

Impact of the Phaseout (Income Limit) and Nonrefundability

As shown in **Table 3**, taxpayers claiming the adoption tax credit accounted for only .07% of all tax returns, reflecting a relatively small number of all taxpayers claiming the adoption tax credit. Few taxpayers claiming the adoption tax credit had an AGI of less than \$30,000 or more than \$200,000. As shown in **Table 3**, the average credit for every AGI class was below the maximum adoption tax credit. However, the average credit increases with the AGI class, reflecting the increase in tax liability to offset with the credit. The exception is the \$200,000 or more AGI class in which few taxpayers claim the adoption tax credit, reflecting the phaseout of the adoption tax credit.

Table 3. Utilization of the Adoption Tax Credit, Tax Year 2004

| Adjusted Gross Income Class | Total Tax Returns | Tax Returns with the Adoption Tax Credit | Share of Total Tax Returns | Amount of Adoption Tax Credit | Average Credit Amount per Return |
|------------------------------|--------------------|--|----------------------------|-------------------------------|----------------------------------|
| Under \$30,000 | 67,407,107 | 3,775 | 0.01% | \$2,452,000 | \$650 |
| \$30,000 to under \$50,000 | 24,839,017 | 22,098 | 0.09% | \$30,889,000 | \$1,398 |
| \$50,000 to under \$75,000 | 18,854,917 | 30,625 | 0.16% | \$98,193,000 | \$3,206 |
| \$75,000 to under \$100,000 | 11,140,408 | 16,623 | 0.15% | \$64,195,000 | \$3,862 |
| \$100,000 to under \$200,000 | 12,088,423 | 19,439 | 0.16% | \$150,208,000 | \$7,727 |
| \$200,000 and over | 4,064,884 | 809 | 0.02% | \$5,248,000 | \$6,487 |
| Total | 138,394,754 | 93,369 | 0.07% | \$351,184,000 | \$3,761 |

Source: Table prepared by the Congressional Research Service (CRS) from Internal Revenue Service, *Individual Complete Report, Publication 1304*, Table 3.3.

The percentage of total tax returns using the adoption tax credit has increased since tax year 1997, the first year of the credit, when .03% of total tax returns claimed the adoption tax credit. The change to the phase-out income level made by the Economic Growth and Tax Relief Reconciliation Act (EGTRRA, P.L. 107-16)⁴⁴ significantly increased the percentage of tax returns with an adjusted gross income between \$100,000 and \$200,000 claiming the adoption tax credit (from .03% in tax year 2000 to .16% in tax year 2004).

Making the adoption tax credit refundable may allow more taxpayers at lower levels of AGI to benefit from the adoption tax credit. However, doing so would increase the cost of the credit. The current cost of the adoption tax credit is relatively small (\$351.2 million in credit claimed in tax year 2006); in contrast, in tax year 2006, \$3.5 billion was claimed for the child and dependent care credit and \$31.7 billion for the child tax credit cost. One consideration in making the adoption tax credit refundable is an issue that arises with all refundable tax credits—the refundable tax credit may encounter overclaim problems similar to those experienced with the Earned Income Tax Credit (EITC).⁴⁵

The amount of the adoption tax credit is limited by tax liability (after other nonrefundable tax credits), not by the cost of the adoption. As AGI increases, larger amounts of the adoption tax credit can be used to offset tax liability (and reduce the final adoption cost). Therefore, assuming a taxpayer adopting a child out of foster care has qualified adoption expenses, that taxpayer has a greater chance of having those costs covered by the adoption tax credit. This is because foster care adoptions are the least expensive, with costs ranging from \$0 to \$2,500. However, even to reach \$2,500 of tax liability, a taxpayer must have an AGI of approximately \$50,000.⁴⁶ Because of the carryover provision, any adoption tax credit not claimed in the current tax year may be claimed in future tax years (up to five tax years).

Because costs tend to be much higher for domestic private adoptions and intercountry adoptions, a taxpayer will have to have a higher AGI (and higher tax liability) to utilize the maximum value of the adoption tax credit (and recover more of the adoption costs). Where the adoption costs are greater than the maximum value of the credit (which may be the case for some domestic private adoptions and intercountry adoptions), the taxpayer will not recover the full cost of the adoption through the adoption tax credit, even if the taxpayer can claim the maximum adoption tax credit. For example, if an adoption costs a taxpayer \$30,000, the taxpayer will receive the maximum adoption tax credit if his or her AGI is between approximately \$102,000 and \$174,730. However, the final adoption costs will still be greater than the maximum adoption tax credit.

As a result of the phaseout (income limitation) and nonrefundability of the tax credit, many taxpayers may not be able to take the full adoption tax credit for an adoption. This raises the policy issue of whether, and how, to expand the tax provisions to increase the use of the tax provisions, and whether federal and state subsidies may be more efficient than tax provisions in helping offset the costs of adoption.

⁴⁴ EGTRRA (P.L. 107-16) raised the income threshold for the phaseout of the adoption tax credit from \$75,000 to \$150,000.

⁴⁵ For information on the policy issues for the EITC, see CRS Report RS21477, *The Earned Income Tax Credit (EITC): Legislative Issues*, by Christine Scott.

⁴⁶ Ibid. Many children adopted out of the foster care system meet the definition of “special needs” included in the tax code, and as described in the text above, a taxpayer does not need to have any qualifying adoption expenses to claim the full amount of the adoption tax credit.

Federal/State Subsidies Versus Tax Incentives

Congress considered the efficiency of adoption tax provisions and adoption subsidy programs in the 1980s. In 1980, the federal government began sharing (with the states) the cost of providing monthly subsidies for parents who adopt children with special needs (Adoption Assistance and Child Welfare Act of 1980, P.L. 96-272). This federal adoption assistance program, which helps parents with the ongoing costs of raising an adoptive special needs child, is authorized under Title IV-E of the Social Security Act. In 1981, the Economic Recovery Tax Act (P.L. 97-34) established an itemized tax deduction for certain costs of adopting a child with special needs. The provision was intended to encourage adoption of special needs children by relieving some of the financial burden for taxpayers.⁴⁷

In 1986, the Tax Reform Act (P.L. 99-514) repealed the itemized deduction and instead expanded the Title IV-E program to require that states provide direct assistance to adoptive parents to help with the initial and nonrecurring costs of adopting a special needs child. That legislation also authorized federal matching grants to states for this purpose, which, as implemented, range up to \$2,000 for an adoptive family, with the federal government reimbursing 50% (\$1,000) of the cost to the state. In making this change, Congress believed that the itemized tax deduction provided the greatest benefit to high-income earners.⁴⁸ Congress also believed that agencies with expertise in placing children with special needs should have budgetary control over adoption assistance, and that grant programs would facilitate more appropriate federal spending than the tax system.⁴⁹

Since 1997, however, when P.L. 104-188 first provided for an adoption tax credit, federal assistance for adoption has been provided through both grant programs and the tax code.

Special Needs Children Versus Non-special Needs Children

Although the maximum amount of qualified expenses is the same for all adoptions, a taxpayer who adopts a special needs child is assumed to have incurred the maximum amount of qualified expenses (regardless of actual expenses) and, therefore, has the maximum adoption tax credit.

Special needs children, by definition, are considered hard to place for adoption without assistance to their adoptive parents. Providing a preference for one type of adoptive child over another in the federal tax code may be viewed as unfair or inequitable—a taxpayer adopting a special needs child receives a larger tax benefit than a taxpayer adopting a non-special needs child, even if both taxpayers have the same total costs of adoption. However, the preference for special needs children is a policy decision made by Congress to encourage adoption of children who might otherwise enter adulthood without a permanent family.⁵⁰

⁴⁷ Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981*, JCS-10-87, December 29, 1981, pp. 57-58.

⁴⁸ The use of federal matching grants provided assistance to a greater range of families.

⁴⁹ Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, May 4, 1987, pp. 52-53.

⁵⁰ The preference for special needs children has existed since the itemized deduction for adoption expenses, which was *only* for the adoption of a special needs child, was established by the Economic Recovery Tax Act of 1981 (P.L. 97-34). The adoption tax credit established by P.L. 104-188 also contained a preference for special needs children in the form of a higher limit on qualified expenses for the adoption of a special needs child. EGTRRA (P.L. 107-16) established that beginning in tax year 2003, a taxpayer adopting a special needs child was assumed to have the maximum amount of qualified adoption expenses for the adoption tax provisions.

Domestic Adoptions Versus Intercountry Adoptions

Federal tax assistance for adoption provides incentives for both domestic (public and private) and intercountry adoptions. However, domestic adoptions are favored under the tax provisions for adoption because for a domestic adoption, qualifying expenses may be claimed even if a domestic adoption does not finalize.⁵¹ Intercountry adoptions *must* become finalized *before* a taxpayer can claim any qualifying expenses for the tax credit or income tax exclusion.⁵² Intercountry adoptions are typically considered more expensive and less predictable for finalization than domestic adoptions.⁵³ A family may spend a great deal of money for an intercountry adoption, but will not receive a tax benefit if something prevents the adoption from becoming final. The preference in the federal tax provisions for domestic adoption may be considered inequitable or unfair by some families that do not receive a tax benefit because their intercountry adoption was not finalized.

EGTRRA

A current policy issue surrounding the tax credit and income tax exclusion is the sunset of certain provisions established in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16). EGTRRA provided for an increase in the maximum qualified expenses and increased the amount of income where the credit phaseout begins (the income limitation). However, to remain in compliance with the Congressional Budget Act, EGTRRA included a sunset provision—the changes will expire and, in 2011, prior law will take effect. Taxpayers, beginning in tax year 2011, will be allowed to claim up to \$5,000 in qualified expenses for non-special needs children and up to \$6,000 for special needs children (all expenses must be documented, regardless of special needs status). Taxpayers with incomes greater than \$75,000 will receive a reduced adoption tax credit (because of the phaseout), and taxpayers with incomes greater than \$115,000 (\$40,000 above the threshold) will not be eligible for the adoption tax credit.

Legislative History

As noted earlier, federal tax assistance for adoption began with the Economic Recovery Tax Act of 1981 (P.L. 97-34), which provided an itemized deduction for adoption expenses, which was repealed by the Tax Reform Act of 1986 (P.L. 99-514). However, the 1986 law also amended Title IV-E of the Social Security Act to require states to make direct payments to parents adopting children with special needs to help offset the nonrecurring costs of adoption (attorney fees, court costs, etc.) and authorized 50% federal matching funds to states for these purposes.⁵⁴

Several bills subsequently introduced proposed tax incentives for adoption. Tax provisions for adoption (a tax credit and income tax exclusion for employer provided adoption programs) were included in the Balanced Budget Act of 1995 (H.R. 2491, 104th Congress),⁵⁵ which was vetoed by

⁵¹ IRC § 23.

⁵² Ibid.

⁵³ DHS, ACF; Children's Bureau, NAIC.

⁵⁴ Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, May 4, 1987, pp. 52-53.

⁵⁵ This legislation is also referred to as the Seven-Year Balanced Budget Reconciliation Act of 1995, the original title (continued...)

President Clinton (for reasons unrelated to the adoption tax provisions). The Adoption Promotion and Stability Act of 1996 (H.R. 3286, 104th Congress) also proposed an adoption tax credit and income tax exclusion. The Finance Committee report on the bill noted that one justification for the adoption tax provisions was that the financial costs of adoption should not be a barrier to adoption.⁵⁶

The Small Business and Job Protection Act of 1996 (P.L. 104-188)

P.L. 104-188 provided a federal tax credit and income tax exclusion to taxpayers for qualified adoption expenses. Qualifying expenses were limited to \$5,000 for an adoption and to \$6,000 for the adoption of a special needs child. P.L. 104-188 provided a phase-out provision that reduced the tax benefits for taxpayers with incomes of more than \$75,000 and less than \$115,000. P.L. 104-188 also included a carryover provision so that a taxpayer with more adoption tax credit than tax liability could carryover the excess tax credit for up to five years. Finally, the act provided several definitions and special rules (that remain in current law), including qualifying expenses, eligible child, child with special needs, and special rules for intercountry adoptions.

The Taxpayer Relief Act of 1997 (P.L. 105-34)

P.L. 105-34 clarified that the adoption tax credit is claimed the tax year after qualified expenses are incurred only when the adoption has not been finalized. Previously, the provision simply stated that the adoption tax credit was claimed the tax year after expenses were incurred, except for expenses incurred the tax year the adoption was finalized (which could be claimed the tax year incurred). P.L. 105-34 also conformed the definition of adjusted gross income for the phaseout of the income tax exclusion to be the same definition of adjusted gross income used for the phaseout the adoption tax credit.

IRS Restructuring and Reform Act of 1998 (P.L. 105-206)

P.L. 105-206 changed the carryover provision of the credit so that the phaseout of the credit applies only in the year in which the credit is generated and does not reduce carryover credit amounts.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGGTRA, P.L. 107-16)

EGGTRA (P.L. 107-16) increased the limit on qualified adoption expenses to \$10,000 for all children (from \$5,000 for non-special needs children and \$6,000 for special needs children). In addition, EGTRRA increased the income level for the beginning of the credit phaseout to \$150,000 (from the previous level of \$75,000) and provided an inflation adjustment for the limit on qualified adoption expenses and the phaseout income level based on the consumer price index

(...continued)

of the legislation as passed by the House of Representatives and before the Senate amendment. The text above uses the title from the conference report (H.Rept. 104-350) agreed to by the House on November 17, 1995.

⁵⁶ U.S. Congress, Committee on Finance, S.Rept. 104-279, Adoption Promotion and Stability Act of 1995, pp. 2-5.

(CPI). EGTRRA also included a sunset provision for the legislation. The changes to the adoption tax provisions are scheduled to expire in 2011.

Congress believed that the EGTRRA provisions were necessary to continue to encourage adoptions. This belief was based on reported increases in adoption expenses and the success of the tax credit and income tax exclusion in reducing the final costs of adoption for taxpayers.⁵⁷

The Job Creation and Workers Assistance Act of 2002

The Job Creation and Workers Assistance Act (P.L. 107-147) clarified that qualifying expenses for the adoption of children with special needs do not need to be documented. Therefore, a family seeking to adopt a child with special needs could claim the maximum credit without having to document expenses (P.L. 107-147). The conference report accompanying H.R. 1836 (EGTRRA, P.L. 107-16) provided that the maximum amount of qualifying expenses was assumed to have been claimed (without the documentation requirement) in the case of a special needs adoption for tax years beginning after 2002. However, the legislative language of EGTRRA did not make this provision clear. Therefore, a technical correction was made in P.L. 107-147.⁵⁸ P.L. 107-147 also provides that any qualifying expenses incurred prior to tax year 2002 are subject to the pre-EGTRRA provisions. In other words, expenses incurred prior to 2002 were limited to qualifying expenses of \$5,000 for non-special needs children and \$6,000 for special needs children. Taxpayers claiming expenses prior to 2002 were also subject to the phaseout income level that existed prior to EGTRRA.

Legislation in the 110th Congress

In the 110th Congress, legislation was introduced (H.R. 273, H.R. 471, H.R. 3758, S. 561, and S. 3079) that would have repealed the EGTRRA sunset provision as it relates to the adoption tax provisions. H.R. 1074, H.R. 3192, H.R. 7091, and S. 2407, would have increased the maximum qualified expenses from \$10,000 to \$15,000 (with an inflation adjustment) and made the adoption tax credit refundable. H.R. 4313 would have provided an additional \$2,000 of tax credit for adopting an older child.

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⁵⁷ Joint Committee on Taxation, *General Explanation of Tax Legislation in the 107th Congress*, JCS-1-03, January 24, 2003.

⁵⁸ U.S. Congress, Committee on Ways and Means, *Economic Growth and Tax Relief Reconciliation Act of 2001, Conference Report to Accompany H.R. 1836*, H.Rept. 107-084, May 26, 2001, pp. 140-141.