



# In Focus: The Adoption Tax Credit

## OVERVIEW: THE ADOPTION TAX CREDIT

The first federal adoption tax credit was introduced in the Adoption Promotion and Stability Act (APSA) of 1996.<sup>1</sup> It became part of U.S. tax law that same year when the APSA was subsumed in the Small Business and Job Protection Act (P.L. 104-188). At that time the credit provided for qualified adoption expenses up to \$5000 for an adoption, and up to \$6000 for an adoption of a child with special needs. Congressional intent in implementing the federal adoption tax credit in 1996 was to create a tax incentive for families to adopt as well as “to help families defray adoption costs.” Members of Congress urged that “the financial costs of the adoption process should not be a barrier to adoption.”<sup>2</sup>

The federal adoption tax credit gained its current notoriety in 2001 after President George W. Bush signed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA, P.L.107-16). EGTRRA included a provision which expanded the credit to \$10,000 and allowed for inflation adjustments of the credit in subsequent years. The new law also allowed for adoptions of special needs children to receive a “flat credit,” meaning these adoptions were eligible for the full credit regardless of expenses.

Despite the existence of the tax credit, affordability of adoptions continues to be an issue for some families. Among the three types of adoptions: Private domestic adoptions, public domestic adoptions (foster care adoptions), and private intercountry adoptions, costs vary greatly. Fees can range from zero to \$2500 for public domestic adoptions, up to \$25,000 for private domestic adoptions, and at times upwards of \$40,000 for private intercountry adoptions.

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<sup>1</sup> Adoption Promotion and Stability Act, 104<sup>th</sup> Cong. (1996).

<sup>2</sup> U.S. Congress, Committee on Finance, S.Rept. 104-279, Adoption Promotion and Stability Act of 1995.

While anecdotally we know the adoption tax credit is very popular among adoptive parents and is instrumental in their decision to adopt, data is not yet available to confirm to what extent this credit is being used. According to a 2007 Department of the Treasury Report with available data through the 2004 tax year (two years after the last changes were made), 0.07% of all taxpayers claimed the adoption tax credit in 2004 for a total amount of \$351,184,000 and an average credit of \$3,761 per taxpayer.<sup>3</sup>

## DETAILED LEGISLATIVE HISTORY

### Small Business and Job Protection Act (1996)

This law introduced the federal adoption tax credit for qualified adoption expenses up to \$5000 for an adoption or \$6000 for an adoption of a special needs child. Additionally, the bill provided a “phase-out provision”, meaning that the law set a maximum income limit above which families cannot claim the full credit. Taxpayers with incomes above this ceiling may claim a reduced credit or no credit.<sup>4</sup> The law also allowed for a carryover of the credit so that families for whom the credit is larger than the amount of their tax liability in a given year may carryover the excess for up to five years, or until the maximum credit amount is claimed – whichever comes first. Finally, the adoption tax credit is a “nonrefundable” tax credit – it can only offset a person’s tax liability after other nonrefundable credits have been applied. The result is that “[t]he lower the taxpayer’s liability, the lower the benefit from the credit.”<sup>5</sup>

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<sup>3</sup> Department of the Treasury, *Federal Income Tax Benefits for Adoption, Use By Taxpayers, 1999-2005*, June p.44.

<sup>4</sup> Scott, *Tax Benefits for Families: Adoption*, p.6.

<sup>5</sup> Ibid.



The law also defined key terms related to the adoption tax credit:

*Qualifying expenses* – these are “reasonable and necessary adoption fees, court costs, attorney fees, and other expenses” that are “directly related to, and the principal purpose of which is for, the legal adoption of an eligible child” and that do not violate state or federal law. Expenses for surrogacy contracts and stepparent adoptions are not qualified expenses.

*Eligible child* – a child under the age of 18 or individuals who cannot physically or mentally care for themselves. (Further, and quite significantly in terms of the sunset provision in this law, Section 1807 limits this definition only to children with special needs “in the case of qualified adoption expenses paid or incurred after December 31, 2001.”)<sup>6 7</sup>

*Child with special needs* – a child that states determine “cannot or should not be returned to the home of his parents,” and that “there exists with respect to the child a specific factor or condition (such as his ethnic background, age, or membership in a minority or sibling group, or the presence of factors such as medical conditions or physical, mental, or emotional handicaps) because of which it is reasonable to conclude that such child cannot be placed with adoptive parents without providing adoption assistance.”

It also contained special rules regarding intercountry (“foreign”) adoptions which create important distinctions between domestic and intercountry adoptions. The most important to note is that qualified expenses for intercountry adoptions cannot be claimed unless such adoption becomes final. However, for families whose domestic adoptions never reach finalization and fail for some reason, families may still claim the credit.

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<sup>6</sup> P.L. 104-188, §1801(d)(2)(B) defines an “Eligible child” as “a child with special needs” for qualified adoption expenses paid or incurred after December 31, 2001.”

<sup>7</sup> See “Sunset Provision” under *Policy Considerations* section below.

### [Taxpayer Relief Act \(1997\)](#)

Clarification on when the adoption tax credit is to be claimed was provided in this law (P.L. 105-34) – in the year when qualified expenses are incurred, except when an adoption was not finalized in a domestic adoption, in which case the credit may be claimed the year *after* the qualified expenses are incurred.

### [IRS Restructuring and Reform Act \(1998\)](#)

A refining of the carryover provision occurred here in P.L.105-206 so that the phase-out limitation (income limit) of the credit is only calculated in the first year the credit is claimed and doesn’t limit carryover amounts in future years.

### [Economic Growth and Tax Relief Reconciliation Act \(2001\)](#)

Part of President Bush’s broader tax reform measure, the EGTRRA significantly expanded the federal adoption tax credit. The credit was increased to \$10,000 for qualified expenses for all adoptions. It also increased the phase-out provision (income limit) of the credit from \$75,000 to \$150,000 and provided adjustments for inflation on both the \$10,000 limit on qualified expenses and the phase-out limitation. This law created a special rule that for adoptions of special needs children (by definition these are only domestic adoptions, and most often from foster care) taxpayers were no longer required to document qualified expenses. Essentially, for foster care adoptions the maximum limit on qualified expenses is assumed to have been expended and the full credit may be claimed.

### [Job Creation and Workers Assistance Act \(2002\)](#)

While the Conference Report accompanying H.R. 1836 (EGTRRA) provided that the maximum amount of qualifying expenses was assumed to have been claimed (without the need for documentation) in the case of a special needs adoption, the legislative language was not as clear. Therefore, a technical correction was made to clarify that in the case of a special needs adoption, the full credit was assumed to have been claimed regardless of documentation.



### [Fostering Connections to Success and Increasing Adoptions Act \(2008\)](#)

After data showed that significantly fewer families adopting out of foster care utilized the adoption tax credit as opposed to higher numbers of families in private domestic or intercountry adoptions, Section 403 of P.L. 110-351 required that “States inform any individual who is adopting or whom the State is made aware is considering adopting, a child who is in foster care under the responsibility of the State” of their potential eligibility for the federal adoption tax credit.

### [Patient Protection and Affordable Care Act \(2010\)](#)

Section 10909 of President Obama’s health care legislation (P.L. 111-148) included an extension of the adoption tax credit’s sunset provision from December 31, 2010 to December 31, 2011. It also makes the tax credit refundable and expands the credit to its current \$13,170 for 2010, and then indexes this amount for inflation in calendar year 2011.

## **POLICY CONSIDERATIONS**

### **Sunset Provision**

Section 901 of the Economic Growth and Tax Relief Reconciliation Act of 2001 is a general sunset provision that is applicable to the federal adoption tax credit and as a result the law’s changes and enhancements to the credit expire on December 31, 2010, at which point prior law will again take effect for tax year 2011. As noted above, the Patient Protection and Affordable Care Act of 2010 extended this sunset provision by one year to December 31, 2011 – but in 2012 prior law will again take effect. One common point of misconception is that this sunset provision will repeal the adoption tax credit entirely. In fact, the credit will revert from \$10,000 regardless of the type of adoption to its pre-EGTRRA state. As noted above, Section 1807 of the Small Business and Job Protection Act of 1996 defined “eligible child” to create a December 31, 2001 sunset of the \$5000 non-special needs qualified expense credit. This means that if at any time the law were to revert back to its provisions only the \$6000 special needs qualified expenses credit would remain.<sup>8</sup>

<sup>8</sup>P.L. 104-188, §1801(d)(2)(B). See footnote 6.

Similarly, the phase-out provision (income limitation) will revert from \$150,000 back to \$75,000 (meaning families with incomes greater than \$75,000 will receive a reduced adoption tax credit) and families with incomes above \$115,000 will not be eligible for the credit.<sup>9</sup>

Adoptive families have cited the federal adoption tax credit as being instrumental in making their adoption costs affordable, and have urged that this sunset provision be repealed and the adoption tax credit be established permanently.

### **Nonrefundability**

Historically, the federal adoption tax credit has been a nonrefundable tax credit. A nonrefundable tax credit allows taxpayers to lower their tax liability to zero, but not below zero.<sup>10</sup> This is a limitation on the credit, meaning that taxpayers may only apply the credit up to the amount of their tax liability *after* claiming other nonrefundable tax credits that may apply to them. (The child tax credit of \$1000 is applied first, for example) If taxpayers have lower tax liability than the amount of their qualified adoption expenses under the tax credit, they receive a reduced adoption tax credit or none at all. The carryover provision allows for some relief in these circumstances by providing that families may carry the credit forward for up to five years.

*For a thorough explanation and examples of the nonrefundability of the adoption tax credit and its implications, please see CRS Report RL33633, Tax Benefits for Families: Adoption, p.8-10. Information about this report is listed in the last section of this Issue Summary.*

A refundable credit, on the other hand, allows taxpayers to realize the full potential benefit of the credit in the first year they qualify for it. This is because a refundable credit allows taxpayers to reduce their current year tax liability dollar for dollar against the amount of the credit and, if in doing so, there is some credit remaining after their tax liability has reached zero, the government will send them the remainder of the credit in the form of a tax refund.

<sup>9</sup> Small Business and Job Protection Act (1996), P.L. 104-188.

<sup>10</sup> IRS. (2010). *Understanding Taxes Teacher*. Retrieved at [http://www.irs.gov/app/understandingTaxes/teacher/how\\_to\\_d08.jsp](http://www.irs.gov/app/understandingTaxes/teacher/how_to_d08.jsp)



The Patient Protection and Affordable Care Act of 2010 makes the federal adoption tax credit a refundable credit for the first time in its history. However, this same law sunsets the adoption tax credit on December 31, 2011, at which point prior law will go into effect and the adoption tax credit will again be nonrefundable.

Adoption advocates – particularly those who note that families adopting from foster care often have lower tax liability and thus are not able to benefit from the full adoption tax credit – have urged Congress to consider making the adoption tax credit permanently refundable so that families choosing to adopt a child into their home may receive the full credit regardless of their income.<sup>11</sup> Congressional considerations in making the credit permanently refundable are the rise in cost if all families are able to claim the full credit (though the cost of this credit is relatively low compared to other child family related credits), as well as the common problem of overclaiming associated with all refundable credits.<sup>12</sup>

### Foster Care Adoptions

A 2007 Child Trends report summarizes U.S. Treasury data from 1999 to 2005 to show that “[t]he vast majority of adoption tax credit recipients completed private or foreign adoptions rather than adoptions from foster care,” and that “nearly all foreign adoptions were supported by the adoption tax credit, while only 1 in 4 foster care adoptions were.”<sup>13</sup> This report argues that the adoption tax credit’s disproportionate use in international and private domestic adoptions is contrary to the original intent of the adoption tax credit, which was to encourage adoptions from foster care. Questions have been raised as to whether an adoption tax credit is thus the most effective means of encouraging adoptions from foster care, or if perhaps other forms of federal adoption assistance such as grants to states for recruitment of adoptive parents and post adoption services might provide better incentives for families to adopt.<sup>14</sup>

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<sup>11</sup> Geen, Rob. (2007, August). The Adoption Tax Credit: Is it an Effective Approach to Promote Foster Care Adoption? *Child Trends Research Brief*, #2007-24.

<sup>12</sup> C. Scott, p.10.

<sup>13</sup> R. Geen, Effective Approach?, p.1.

<sup>14</sup> Ibid.p.6.

Adoption advocates on both sides of this debate agree that there is a need for better education of families adopting from foster care about their potential eligibility to claim the adoption tax credit, and that such education will likely result in higher numbers of families adopting from foster care claiming the credit. To this end, in 2008, the Fostering Connections to Success and Increasing Adoptions Act (P.L. 110-351, Section 403) addressed this problem by requiring that states inform families adopting or considering adopting a child from foster care about their eligibility for this credit.

### Failed Intercountry Adoptions

Under current law, qualified expenses for a domestic adoption may be claimed for credit even if the adoption never finalizes (the adoption fails).<sup>15</sup> An intercountry adoption, however, must be finalized before a family may claim the credit.

Families whose intercountry adoptions have failed for a variety of reasons have urged that provisions allowing the adoption tax credit be applied to failed domestic adoptions also be applied intercountry adoptions. They state that costs of an intercountry adoption are often for services rendered by agencies rather than contingent on a finalized adoption, and that after investing often times upwards of several thousand dollars in a failed adoption, families are prohibited from attempting to begin a new adoption process due to cost.

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<sup>15</sup> P.L. 104-188



## PENDING ADOPTION TAX CREDIT LEGISLATION IN THE 111<sup>TH</sup> CONGRESS

### ***S.2816: Adoption Tax Relief Guarantee***

Introduced: 11/21/09 Sponsor: Sen. Jim Bunning  
Related Legislation: H.R.213

The Adoption Tax Relief Guarantee Act would repeal the sunset provision on the federal adoption tax credit set forth in EGTRRA of 2001 and make the credit permanent. In addition, this bill will allow families to receive the credit in the year an adoption expense is paid or incurred regardless of whether the adoption was finalized. Under prior law, families whose adoption had not been finalized (their domestic adoption had failed) had to wait until the following taxable year before receiving a tax credit for an adoption expense. The amendments in this bill to the adoption tax credit would apply to adoption expenses paid or incurred in the 2011 taxable year.

### ***H.R.3409: Advocates Dedicated to Older Child Parental Tax Credit (ADOPT) Act of 2009***

Introduced: 7/30/09 Sponsor: Rep. Melissa Bean

The ADOPT Act is a bill to amend the Internal Revenue Code to allow an additional credit against income tax for the adoption of an older child. The bill would assume that a family adopting a “qualified older child” (an eligible child who is 9-years-old on or before the date the child’s adoption is finalized) paid qualified adoption expenses of \$2000 for every year during the “older child allowance period” (the period beginning in the taxable year the adoption is finalized through the taxable year before the child turns 19-years-old). The amendments in this bill would take effect in the 2010 tax year.

### ***H.R.3312: Preventing Unintended Pregnancies, Reducing the Need for Abortion, and Supporting Parents Act***

Introduced: 7/23/09 Sponsor: Rep. Tim Ryan

Section 1601 of this bill focuses on the expansion of the adoption tax credit and would increase the credit to \$15,000 beginning in tax year 2010 and provide an adjustment for inflation in subsequent tax years. The bill would also make the adoption tax credit refundable – meaning that the taxpayer would receive a refund for the full amount of the credit, even in excess of their tax

liability. Additionally, the bill would repeal the sunset provision and make the adoption tax credit permanent.

### ***S.722: Tax Payer Certainty and Relief Act of 2009***

Introduced: 3/26/09 Sponsor: Sen. Max Baucus

Section 203 of this bill repeals the 2001 EGTRRA sunset provision of the adoption tax credit and reduces the threshold credit from \$10,000 to \$3000. The bill would also repeal the yearly inflation adjustment to the credit’s phase-out provision (income limit).

### ***H.R.643: Care for Life Act of 2009***

Introduced: 1/22/09 Sponsor: Rep. Jeff Fortenberry

Section 301 of this bill would increase the credit to \$15,000 and increase the phase-out provision (income limit) from \$150,000 to \$200,000 in tax year 2010, as well as provide for inflation adjustments for both these increased amounts in subsequent tax years. It would also make the adoption tax credit refundable – meaning that the taxpayer would receive a refund for the full amount of the credit. The bill would also repeal the former sunset provision, making the adoption tax credit permanent.

### ***H.R.605: Pregnant Women Support Act***

Introduced: 1/16/09 Sponsor: Rep. Lincoln Davis  
Related Legislation: S.270

Section 1101 amends the Internal Revenue Code to increase and make refundable the tax credit for adoption expenses. The bill would increase the credit to \$15,000 beginning in tax year 2010 and provide an adjustment for inflation in subsequent tax years. The bill would also make the adoption tax credit refundable – meaning that the taxpayer would receive a refund for the full amount of the credit, even in excess of their tax liability. Additionally, the bill would repeal the sunset provision and make the adoption tax credit permanent.

### ***H.R.213: Adoption Tax Relief Guarantee Act of 2009***

Introduced: 1/6/09 Sponsor: Rep. Joe Wilson

Section 2 of this bill exempts provisions expanding the adoption tax credit and adoption assistance programs enacted by the EGTRRA of 2001 from the general sunset provisions of that Act, making the adoption tax credit permanent.



### ***H.R.2035: Pregnant Women Support Act***

Introduced: 4/22/09 Sponsor: Rep. Lincoln Davis  
Related Legislation: H.R.605, S.270, S.1032

See summary of ***H.R.605: Pregnant Women Support Act*** above.

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