

**THE ADOPTION TAX CREDIT:  
PROBLEMATIC IMPLICATIONS FOR LOW-INCOME  
TAXPAYERS**

**Sheldon R. Smith  
Utah Valley State College**

**ABSTRACT**

The federal adoption tax credit was extended and expanded by 2001 legislation. The credit can now be as much as \$10,390 per adoption. This paper provides details for the qualifications and limitations on the expanded credit. It also revisits the implication of these limitations on low-income taxpayers. Examples are given which show that adoptive parents, especially low-income taxpayers, may lose some of the credit when the carryforward period expires or may require several years to take advantage of the credit. The difficulty in these situations may be compounded for foreign adoptions or adoptions of children with special needs. The difficulty of coordinating the credit with the tax exclusion for employer adoption assistance payments is also reviewed as it relates to low-income taxpayers. Potential considerations for future tax policy decisions are mentioned.

**KEY WORDS:** Adoption tax benefits, adoption tax credit, low-income taxpayers, tax policy

## INTRODUCTION

The Small Business Job Protection Act of 1996<sup>1</sup> included a provision for an adoption tax credit of up to \$5,000 (or up to \$6,000 for adoptions of children with special needs) for adoptive parents. The credit only covered adoption expenses incurred after 1996, but the law also had a sunset provision such that the credit would have expired at the end of 2001 (except for the credit associated with an adoption of a child with special needs which was not scheduled to expire).

The credit was extended and expanded by legislative action as part of the Economic Growth and Tax Relief Reconciliation Act of 2001<sup>2</sup>. The credit was expanded to a maximum of \$10,000, but this amount was indexed so the limit is \$10,390 for the 2004 tax year.

Smith and Tew<sup>3</sup> described some ironies of the original adoption tax credit. One of these ironies related to the actual benefits low-income taxpayers might “lose” because of the nature of the credit and its qualifications and limitations. Smith and Tew<sup>4</sup> also included calculations of the minimum adjusted gross income that would be needed in different scenarios so that adoptive taxpayers would not lose any of the credit.

This paper revisits the problematic implications for low-income taxpayers resulting from the expanded adoption tax credit and raises the public policy question whether these implications are intended and/or appropriate. Details of the expanded credit are given in the next section followed by a section with the implications for low-income adoptive taxpayers.

---

<sup>1</sup> H.R. 3448, 104<sup>th</sup> Cong., 2<sup>nd</sup> Sess. (1996)(enacted).

<sup>2</sup> H.R. 1836, 107<sup>th</sup> Cong., 1<sup>st</sup> Sess. (2001)(enacted).

<sup>3</sup> Sheldon R. Smith and Glade K. Tew, *Ironies of the Adoption Tax Credit*, Tax Notes, October 4, 1999, 83-89.

<sup>4</sup> *Id.*

### ADOPTION TAX CREDIT

The adoption tax credit is now limited to \$10,390, but other limitations besides this dollar limit also apply. The credit can only be claimed for qualified adoption expenses actually paid by the adoptive parents. “Qualified adoption expenses” means reasonable and necessary adoption fees, court costs, attorney fees, and other expenses which are directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer.<sup>5</sup> Qualified adoption expenses do not include costs “incurred in violation of State or Federal law” or costs involved with an agreement for surrogate parenting.<sup>6</sup> In addition, expenses which are reimbursed by an employer or otherwise or which are paid for the adoption of a stepchild do not qualify for the credit.<sup>7</sup>

An income limitation exists as well. The benefit of the credit phases out on a proportionate basis for taxpayers with modified adjusted gross income (modified AGI)<sup>8</sup> between \$155,860 and \$195,860 for the 2004 tax year.<sup>9</sup>

In the case of the adoption of a domestic child, the credit can be claimed in the year after payment for expenses paid prior to the year the adoption becomes final.<sup>10</sup> For expenses paid during the year the adoption is finalized or after, the credit can be claimed in the year of payment.<sup>11</sup> The \$10,390 dollar limit on the credit is per adoption effort, not per year. If costs are incurred on an

---

<sup>5</sup> I.R.C. §23.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> To calculate modified AGI for purposes of this credit, AGI is increased by any foreign earned income exclusion, any foreign housing exclusion or deduction, and any exclusion for income from Guam, American Samoa, Northern Mariana Islands, or Puerto Rico. See I.R.S. Publication 968 (For use in preparing 2003 Returns).

<sup>9</sup> The original modified AGI phase-out range was \$75,000 - \$115,000. The 2001 legislation increased the range to \$150,000 - \$190,000, but provided for indexing of the lower limit on the \$40,000 phase-out range. See I.R. C. §23.

<sup>10</sup> Domestic adoption attempts do not have to result in a successful finalization for the costs to qualify for the adoption tax credit.

<sup>11</sup> I.R.C. §23.

unsuccessful adoption attempt followed by additional costs on a successful adoption attempt, these costs are all treated as part of one adoption effort<sup>12</sup> and are subject to the \$10,390 limit.

The adoption tax credit is a nonrefundable credit but can be used to offset the regular tax liability and the alternative minimum tax. However, in conjunction with the other nonrefundable credits,<sup>13</sup> the adoption tax credit cannot reduce the tax liability below zero. However, the credit can be carried forward up to five years beyond the original year of the credit.<sup>14</sup>

The adoption tax credit for adoptions of foreign children cannot be claimed unless and until the adoption is finalized. Therefore, the timing rules are slightly different. Expenses paid in or before the year of finalization are eligible for the credit in the year of finalization.<sup>15</sup>

The determination that a child has special needs is made by the states. In essence, the state must determine that the child should not be returned to the home of his/her parents and that a specific factor or condition exists that makes it difficult for the child to be placed with adoptive parents without adoption assistance. In addition, a foreign child cannot qualify as a child with special needs.<sup>16</sup>

The credit for adoptions of children with special needs changed with the new law. Under the previous law, the credit had a larger dollar limit (\$6,000) for adoptions of children with special

---

<sup>12</sup> I.R.S. Publication 968.

<sup>13</sup> Originally, the child tax credit was a nonrefundable credit, at least as it applied to the first two children in a family. Families with three or more qualifying children were able to get a refundable credit through the additional child tax credit, limited by the amount of payroll taxes paid by the taxpayer. However, the Economic Growth and Tax Relief Reconciliation Act of 2001, H.R. 1836, 107<sup>th</sup> Cong., 1<sup>st</sup> Sess. (2001)(enacted), made the child tax credit partially refundable, even for the first two qualifying children. The Working Families Tax Relief Act of 2004, H.R. 1308, 108<sup>th</sup> Cong., 2<sup>nd</sup> Sess. (2004)(enacted), expanded this partial refundability even further.

<sup>14</sup> I.R.S. Publication 968.

<sup>15</sup> *Id.*

<sup>16</sup> I.R.C. §23.

needs than for adoptions of other children (limit of \$5,000). Under the current law, the limit is \$10,390 for all adoptions. However, for years after 2002, the full credit (\$10,390 for 2004) for a child with special needs can be claimed regardless of expenses incurred.

Additional requirements exist for the credit. Married couples must file joint returns to claim the credit. A taxpayer identification number must be provided for the child in order to claim the credit.<sup>17</sup> If no taxpayer identification number can be provided for the child because of an unsuccessful adoption, then “the name and address of any agency or agent (such as an attorney) that assisted in the attempted adoption” must be provided.<sup>18</sup>

### **IMPLICATIONS FOR LOW-INCOME TAXPAYERS**

Because the adoption tax credit is nonrefundable, taxpayers may lose some of its benefit if they don't have much tax liability. Perhaps because of the large dollar amount of the credit in conjunction with its nonrefundability, the law allows the credit to be carried forward for up to five years. Even so, the implications for low-income taxpayers may be bleak, especially if they don't fully understand the limitations on the adoption tax credit before they make decisions about adoptions and adoption costs.

While many parents who adopt may do so regardless of the tax benefits offered, some adoptive parents, especially those with lower incomes, may consider more costly adoption alternatives because of the existence of an adoption tax credit. In these cases, knowing a little, but not a lot, about the adoption tax credit can actually end up being a dangerous thing. If adoptive parents choose more expensive adoption alternatives because of the existence of the credit, they may find out later that the credit is only available to them over an extended time period. For some low-income adoptive parents, some or all of the credit may actually be lost when the carryforward period expires.

---

<sup>17</sup> *Id.*

<sup>18</sup> I.R.S. Instructions for Form 8839 (Rev. March 2003) at 2.

**Minimum Income Needed to Take Advantage of Full Credit**

Exhibit 1 illustrates the minimum adjusted gross income needed to take full advantage of the adoption tax credit over six years (the original year of the credit plus five carryforward years) for three different scenarios. It uses the 2004 tax rate schedule for a married couple filing a joint return, the 2004 standard deduction, and the 2004 exemption amount.<sup>19</sup> The exhibit works backward from the tax liability needed to take full advantage of one-sixth of the potential adoption tax credit to the AGI necessary to reach this tax liability. For a family with no other children, the minimum AGI needed to take advantage of the full adoption tax credit over six years is \$35,311.11 if one child is adopted, \$49,955.56 if two children are adopted simultaneously, and \$64,600.00 if three children are adopted simultaneously.

---

<sup>19</sup> H.R. 2, 108<sup>th</sup> Cong., 1<sup>st</sup> Sess. (2003)(enacted) amended the tax rate schedules for 2003 and increased the standard deduction for married couples filing jointly (for 2003 and 2004). The amended tax rate schedule and the new standard deduction amount were used for the calculations in the exhibits and in the paper. The Working Families Tax Relief Act of 2004, H.R. 1308, 108<sup>th</sup> Cong., 2<sup>nd</sup> Sess. (2004)(enacted), extended the amendments to the tax rate schedule and the increased standard deduction for married couples filing joint returns.

Exhibit 1 <sup>20</sup>						
2004 Adjusted Gross Income Levels Needed to Take Advantage of a Full \$10,390, \$20,780, or \$31,170 Adoption Tax Credit Over Six Years* (based on 2004 standard deduction and exemption amounts and the 2004 tax rate schedule for a married couple filing a joint return)						
	One child adopted/ no other children		Two children adopted/ no other children		Three children adopted/ no other children	
Total Potential Adoption Tax Credit (ATC)	\$10,390		\$20,780		\$31,170	
Tax Liability Needed to Take 1/6 of the ATC	\$1,732		\$3,463		\$5,195	
Split between tax brackets	\$1,430	\$302	\$1,430	\$2,033	\$1,430	\$3,765
Divided by Tax Rates	0.10	0.15	0.10	0.15	0.10	0.15
Taxable Income Needed (Sum)	\$16,311		\$27,856		\$39,400	
Add: Standard Deduction	\$9,700		\$9,700		\$9,700	
Add: \$3,100 per Exemption	\$9,300		\$12,400		\$15,500	
Adjusted Gross Income Needed	\$35,311		\$49,956		\$64,600	
* Table works backwards from the tax liability needed to take full advantage of one-sixth of the ATC to arrive at the AGI necessary to reach this tax liability.						

<sup>20</sup> Adapted and updated from Sheldon R. Smith and Glade K. Tew, *Ironies of the Adoption Tax Credit*, Tax Notes, October 4, 1999, 83-89 at 85. The child tax credit is not included in this exhibit because of more generous rules about the refundability of the child tax credit which now exist. However, the child tax credit could still be an issue in some cases.

In some ways, the assumptions used to create the exhibit are conservative (tend to decrease AGI needed), and in other ways the assumptions used are liberal (tend to increase AGI needed). One liberal assumption is that each adoption costs the taxpayers at least \$10,390 after considering any employer adoption benefits<sup>21</sup> or other reimbursements. While some adoptions do not cost \$10,390, many adoptions cost much more than \$10,390.<sup>22</sup> Adoptive parents who have less than \$10,390 of out-of-pocket costs for an adoption would not need as much income to claim the entire credit they otherwise qualify for. However, a significant number of adoptions do cost at least \$10,390, so the numbers in the table are relevant, at least in establishing the limitations of the adoption credit benefits in cases that are not necessarily unusual.

The first column in Exhibit 1 shows the minimum income needed to take full advantage of the adoption tax credit for one adopted child. The other two columns show the calculations if two or three children are adopted simultaneously. While single adoptions are much more common, multiple adoptions, most likely in the case of sibling groups, are possible. However, cases of

---

<sup>21</sup> An exclusion for employer adoption assistance payments is also available through the same legislation as the adoption tax credit.

<sup>22</sup> Department of the Treasury, "Report to The Congress on Tax Benefits for Adoption," October 2000, accessed from <http://www.ustreas.gov/taxpolicy/library/adoption.pdf> on January 17, 2001. This report cited several ranges of figures for adoption costs which were provided by the National Adoption Clearinghouse, but the source did not include reference year information. For "a non-foreign public agency adoption," the costs ranged from zero to \$2,500. For adoptions through domestic private agencies, the "fees range from \$4,000 to \$30,000 and more." For "independent (without an agency) non-foreign adoptions," the range is "from \$8,000 to \$30,000 and more." "International adoptions are reported at \$10,000 to \$30,000 and more" (p. 17). As a side note, it would be interesting to know if adoption agency fees and adoption legal fees have increased at a rate higher than "normal" cost increases, because of the legislated tax benefits for adoption. In other words, the question remains whether taxpayers are better off with the tax benefits or if they are just required to pay increasing adoption costs which offset the tax benefits received. This question, although interesting, is beyond the scope of this paper.

simultaneous adoption of three or more children would be quite unusual. It is also possible that these adoptions would have some “economies of scale.” If so, it might be less likely that the cost incurred would be a full \$10,390 per child. Nevertheless, it is apparent from the exhibit that a taxpayer eligible for a larger adoption tax credit would need larger income to avoid losing some of it at the end of a carryforward period.

One of the conservative assumptions used in the exhibit was that the adoptive family had no other children. It is certainly possible that adoptive parents have no other children. However, married couples who adopt because they cannot bear children naturally may want two or more children, just like many families who have natural-born children. In addition, some families adopt even though they have already been able to bear one or more children themselves. Thus, the AGI numbers listed at the bottom of the exhibit are conservative for families who already have one or more existing children before adopting. The AGI needed in these cases would increase by \$3,100 per child for the extra exemption allowance.

Another conservative assumption in the exhibit is that no other nonrefundable credits are assumed. However, if adoptive taxpayers can also claim other nonrefundable credits, their income would have to be even higher to take full advantage of the adoption tax credit before some of it expires.

Another liberal assumption is that the exhibit assumes that all of the expenses eligible for the credit become eligible in the same year. This is not necessarily the case. For example, if a family paid some up-front adoption expenses near the end of 2002 and was unable to finalize the adoption until early in 2004, the up-front costs would be eligible for the credit in 2003, and remaining costs paid in 2003 or later would be eligible for the credit in 2004 or later. Thus, it is actually possible for the \$10,390 credit to provide tax benefits over more than 6 years if the original credit is claimed over more than one taxable year. This scenario would decrease the AGI needed each year to take full advantage of the adoption tax credit before some of it expires. However, it is likely

for a large portion of adoptions that most or all of the qualifying adoption expenses will have been paid by or soon after the time of finalization. Therefore, it is unlikely a significant amount of expenses will be claimed for the credit in years after finalization.

### **Adoptions of Foreign Children and Children with Special Needs**

The scenario of spreading the credit over more than six years is less likely to apply to foreign adoptions. Since no adoption tax credit can be claimed until the year of finalization and most of the expenses are likely paid at the time of or shortly after finalization, most of the adoption tax credit claimed for foreign adoptions will be claimed in one year, thus meaning the taxpayers will only be able to take advantage of the portion of the credit they can use in six years.

Adoptions of children with special needs are often less expensive than other adoptions, at least for the actual fees and legal costs involved in the adoption process. This may be true both because the actual costs are lower and also because there is more governmental help in paying for these costs. However, the ongoing costs may be much greater if there are special physical, emotional, or mental needs that require expenditures beyond those in raising a child without special needs. These costs might even include structural changes to a house to make it more accessible for a child with a physical disability. Perhaps these are some of the reasons for the legislation of the “automatic” credit for the adoption of a child with special needs.

Since all of these adoptions will come with an “automatic” \$10,390 credit, it is more likely that low-income taxpayers who adopt these children will end up losing some of the credit because it will expire before it is used. In addition, sibling group adoptions may be more likely to qualify as adoptions of children with special needs. Therefore, it is possible that the problem will be compounded for these adoptions because of multiple adoption tax credits, all for an “automatic” \$10,390.

### **Child Tax Credit**

The child tax credit is related to the discussion of the adoption tax credit. The term “eligible child” for the adoption tax credit refers to a child under age 18 or who is “physically or mentally incapable of caring for himself.”<sup>23</sup> For 2003, the term “qualifying child” for the child tax credit referred to a child who (1) can be claimed as a dependent, (2) is under age 17 at the end of the tax year, (3) is a son, daughter, adopted child, stepchild, brother, sister, stepbrother, stepsister (including a descendant of any of those previously mentioned), or foster child of the taxpayer, and (4) is a U.S. citizen or resident alien.<sup>24</sup> Therefore, in many cases, children eligible for the adoption tax credit are also qualifying children for the child tax credit.

Originally, the child tax credit was a nonrefundable credit for families with one or two qualifying children. For families with three or more qualifying children, an additional child tax credit which is refundable, limited by the amount of payroll taxes paid, was available. The child tax credit was another significant implication to adoptive parents with only one or two qualifying children trying to claim the adoption tax credit. It implied that their income also had to be even greater if they were to take advantage of both the child tax credit and the adoption tax credit.<sup>25</sup>

The Economic Growth and Tax Relief Reconciliation Act of 2001<sup>26</sup> liberalized the refundability of the child tax credit, and the Working Families Tax Relief Act of 2004 liberalized it even further.<sup>27</sup> Now the child tax credit is refundable for taxpayers with

---

<sup>23</sup> I.R.C. §23.

<sup>24</sup> I.R.S. 2003 Form 1040 Instructions at 21. The Working Families Tax Relief Act of 2004, H.R. 1308, 108<sup>th</sup> Cong., 2<sup>nd</sup> Sess. (2004)(enacted), modified the definition of qualifying child to make it more uniform with other uses of “qualifying child” in the tax code. This modification does not change the point that, in many cases, children eligible for the adoption tax credit are also qualifying children for the child tax credit.

<sup>25</sup> I.R.C. §24 before amendments made by H.R. 1836, 107<sup>th</sup> Cong., 1<sup>st</sup> Sess. (2001)(enacted).

<sup>26</sup> H.R. 1836, 107<sup>th</sup> Cong., 1<sup>st</sup> Sess. (2001)(enacted).

<sup>27</sup> H.R. 1308, 108<sup>th</sup> Cong., 2<sup>nd</sup> Sess. (2004)(enacted).

one or two qualifying children to the extent of 15 percent of their taxable earned income in excess of \$10,750. For families with three or more qualifying children, the child tax credit is refundable using either the old rules (refundable limited by payroll taxes paid) or the new rules (15% of taxable earned income in excess of \$10,750), whichever provides the greater benefit.<sup>28</sup>

For taxpayers who meet the minimum AGI amounts shown in Exhibit 1, claiming the child tax credit will not likely be a problem. If most or all of their income is earned income, they will be able to take the child tax credit in the form of the refundable additional child tax credit, and thus not reduce the amount of adoption tax credit they can take each year. However, for taxpayers whose income may be substantially lower than these AGI amounts, not only might they lose some of the adoption tax credit, but they might also lose some of the benefit of the child tax credit related to the adopted child(ren) or any child(ren) they have before the adoption.

### **Coordinating the Credit and the Exclusion**

The same laws that created/expanded the adoption tax credit also provide for an exclusion from income for amounts employers pay for employees' adoption costs under an adoption assistance program. Limits similar to those which exist for the credit apply to the exclusion.<sup>29</sup> The adoption credit and exclusion can both be claimed for the same adoption; however, the credit and exclusion cannot be claimed for the same expense. Adoption expenses paid by an employer are not eligible for the credit.<sup>30</sup>

The credit is a 100% credit, meaning the credit is allowed for 100% of the adoption expenses paid up to the dollar limit. Therefore, it provides a dollar-for-dollar benefit to the adoptive taxpayer. An employer payment, even if excludable from income

---

<sup>28</sup> Welfare Information Network, *The Child Tax Credit*, accessed from <http://www.makingwageswork.org/childtaxcredit.htm> on February 22, 2002.

<sup>29</sup> I.R.C. §137.

<sup>30</sup> I.R.S. Publication 968.

taxes, is still subject to social security and Medicare taxes.<sup>31</sup> Therefore, it is not a 100% benefit for the taxpayer in the same way as the credit. In addition, the timing rules for the credit and exclusion are different, the exclusion depending, to a great extent, on when the employer pays or reimburses the adoption costs.

Because of the differences in timing and benefit provided from the credit versus the employer reimbursement, coordinating the exclusion and the credit to provide maximum benefit can be very difficult.<sup>32</sup> Smith and Tew discuss and illustrate this difficulty in coordination, stating that “in some of these cases, the coordination of these items and advance planning would be extremely difficult even for an expert tax professional.”<sup>33</sup>

While the coordination of these two potential adoption tax benefits is beyond the scope of this paper, it is mentioned because it relates to low-income taxpayers. If low-income taxpayers could get all of the credit immediately, they would prefer the 100% credit to the employer reimbursement and exclusion. However, for taxpayers whose income is low enough such that they will require an extended period of time to get the benefit of the credit, an employer reimbursement, where offered, might be a better option. However, even for those who are aware of the choices it may be difficult to determine which option will provide the greatest overall benefit.

### **Other Considerations**

In many cases, adoptive parents are older (and perhaps more educated) than average newlyweds. This occurs because those who adopt after finding themselves unable to bear children are already likely to have been married for some time. Those who

---

<sup>31</sup> *Id.*

<sup>32</sup> Sheldon R. Smith, *The Tax Exclusion for Employer Adoption Assistance Payments: Results of Legislative Changes*, Paper presented at the American Accounting Association Western Region Annual Meeting, April 2002; Sheldon R. Smith, *The Adoption Tax Credit: Results of Legislative Changes*, Proceedings, Western Decision Sciences Institute Annual Meeting, April 2002.

<sup>33</sup> Sheldon R. Smith and Glade K. Tew, *The Adoption Exclusion: Complications for Employees*, Tax Notes, January 29, 2001, 659-664 at 664.

adopt even though they are able to bear children are more likely to do so after having had one or more children naturally, again making them older than average newlyweds. If they are older and more educated, their income level may be higher on average, thus mitigating the concern about low-income taxpayers.

However, even if the concern is mitigated in some cases, there are many adoptive parents who are still in the early stages of their careers, with most of their income potential still to come rather than already being earned. Also, some careers such as public school teaching may never offer a great deal of income, at least in many school districts, even if the career is well established. Thus, the concern that low-income taxpayers may have a difficult time claiming all of the adoption tax credit they otherwise qualify for is relevant.

Also, the concerns raised by the numbers in Exhibit 1 are actually conservative for another reason. Those numbers present the minimum AGI needed to claim the full adoption tax credit over six years. It is likely that adoptive parents do not automatically assume they might lose some of the credit. In fact, it is also likely that many of them do not automatically assume it may take several years to claim the credit. The time value of money is significant over a six-year period. It may be even more significant for those with lower incomes, especially if they assumed they would be able to get a “quick refund” (through the credit) of up to \$10,390 of their adoption costs, only to find out the “refund” will not be quick and perhaps not complete.

Exhibit 2 is similar to Exhibit 1 but shows the minimum AGI necessary to take advantage of a full \$10,390 or \$20,780 adoption tax credit in one year. To take the full \$10,390 credit in one year, the adjusted gross income would need to be \$86,660. To take the full credit of \$20,780 for two adoptions in one year would require an AGI of \$131,320. It is difficult to imagine anyone classifying these income levels as low. In fact, the income levels calculated assume that the taxpayers are claiming the standard deduction. With income levels such as these, it is quite likely the

taxpayers will be itemizing their deductions, thus implying that the income would have to be even higher to take full advantage of the adoption tax credit.

Exhibit 2 2004 Adjusted Gross Income Levels Needed to Take Advantage of a Full \$10,390 or \$20,780 Adoption Tax Credit in One Year* (based on 2004 standard deduction and exemption amounts and the 2004 tax rate schedule for a married couple filing a joint return)						
	One child adopted/ no other children			Two children adopted/ no other children		
Total Potential Adoption Tax Credit (ATC) and Tax Liability Needed to Take Advantage of Full ATC in One Year	\$10,390			\$20,780		
Split between tax brackets	\$1,430	\$6,570	\$2,390	\$1,430	\$6,570	\$12,780
Divided by Tax Rates	0.10	0.15	0.25	0.10	0.15	0.25
Taxable Income Needed (Sum)	\$67,660			\$109,220		
Add: Standard Deduction	\$9,700			\$9,700		
Add: \$3,100 per Exemption	\$9,300			\$12,400		
Adjusted Gross Income Needed	\$86,660			**\$131,320		
<p>* Table works backwards from the tax liability needed to take full advantage of the ATC to arrive at the AGI necessary to reach this tax liability.</p> <p>** For a married couple filing a joint return, the child tax credit is reduced "by \$50 for each \$1,000 (or fraction thereof) by which the taxpayer's modified adjusted gross income exceeds" \$110,000.<sup>34</sup> Modified AGI for purposes of the child tax credit has the same definition as it does for the adoption tax credit (see footnote 8). Therefore, a couple with the level of AGI in this column, even without any adjustments to get to modified AGI, would not be able to claim the entire child tax credit for the two adopted children.</p>						

---

<sup>34</sup> I.R.C. §24.

Without showing all of the calculations, Exhibit 3 shows the minimum AGI needed to take a full \$10,390 adoption credit over one, two, three, four, five, or six years, assuming the family has no children prior to the adoption. Again, for situations in both Exhibit 2 and Exhibit 3, the amounts would be larger if the family already had other children before the adoption. It becomes apparent from the numbers in Exhibit 3 that low-income taxpayers may have a difficult time receiving the entire benefit of the adoption tax credit if they have \$10,390 of credit to claim. And even in situations where their income is large enough to claim the entire credit, it will likely take several years for them to receive the benefit of that credit.

Exhibit 3 2004 Adjusted Gross Income Levels Needed to Take Advantage of a Full \$10,390 Adoption Tax Credit in One, Two, Three, Four, Five, or Six Years, Assuming No Other Existing Children (based on 2004 standard deduction and exemption amounts and the 2004 tax rate schedule for a married couple filing a joint return)						
	1 Year*	2 Years	3 Years	4 Years	5 Years	6 Years**
AGI Needed	\$86,660	\$58,400	\$46,856	\$41,083	\$37,620	\$35,311
* Calculations shown on Exhibit 2 ** Calculations shown on Exhibit 1						

### DISCUSSION AND CONCLUSION

Some may complain that the adoption tax credit may simply be a windfall to parents who would have adopted anyway. Some may claim that it has the potential of increasing adoption agency and legal fees for adoption, thereby funneling the benefit of the credit through to facilitators rather than to adoptive parents. On the other hand, this tax credit may help reduce foster care costs by facilitating earlier adoptions for some children and any adoption for others. Hopefully, it will also allow more children to be adopted into happy family situations where they can become productive and experience increased opportunities for success. Therefore, this adoption tax credit has government revenue/cost implications as well as social and public policy implications.

Adoption tax benefits have broad bipartisan support from a public and political policy perspective. A U.S. House bill, H.R. 1057, was passed unanimously (414-0) in September 2004.<sup>35</sup> This

<sup>35</sup> U.S. House. 108<sup>th</sup> Cong., 2<sup>nd</sup> Sess. H.R. 1057, *The Adoption Tax Relief Guarantee Act*. ONLINE. 23 September 2004. Thomas. Available:

bill is designed to make the adoption tax benefits permanent, as the Economic Growth and Tax Relief Reconciliation Act of 2001 has a sunset provision such that these benefits will expire after 2010. Three other bills have been introduced in 2005, either in the U.S. House or Senate, which would accomplish the same objective.<sup>36</sup>

In addition to these bills designed to make the tax benefits permanent, two other bills have been introduced in the U.S. House in 2005 which would have a direct impact on how low-income taxpayers might benefit from the adoption tax credit. H.R. 347<sup>37</sup> would repeal the 5-year carryforward limit on the adoption tax credit, thus making it possible for a larger number of low-income taxpayers to get more benefit from the adoption tax credit since they could claim the credit with no expiration. Another bill, H.R. 1561,<sup>38</sup> would make the adoption tax credit refundable rather than nonrefundable. Although this bill would also benefit some higher-income taxpayers, it would have a direct impact for low-income taxpayers in that no credit carryforward would be required, as any credit would provide an immediate tax benefit for the year in which the credit was claimed.

The purpose of this paper is not to argue that this credit should become refundable or that the carryforward period should be extended. The concern is not so much whether the credit should be refundable or nonrefundable. That is more of a social policy issue which also relates to revenue/cost implications to the government. The concern is that the credit is easy to misunderstand, and this misunderstanding can lead to unexpected results, especially for low-income taxpayers. Thus, from a policy standpoint, legislators should make sure the ramifications of the

---

<http://thomas.loc.gov/home/r108query.html> [11 May 2005].

<sup>36</sup> U.S. House. 109<sup>th</sup> Cong., 1<sup>st</sup> Sess. H.R. 268 and H.R. 305. ONLINE. Thomas. Available: <http://thomas.loc.gov> [11 May 2005] and U.S. Senate. 109<sup>th</sup> Cong., 1<sup>st</sup> Sess. S. 246. ONLINE. Thomas. Available: <http://thomas.loc.gov> [11 May 2005].

<sup>37</sup> U.S. House. 109<sup>th</sup> Cong., 1<sup>st</sup> Sess. H.R. 347. ONLINE. Thomas. Available: <http://thomas.loc.gov> [11 May 2005].

<sup>38</sup> U.S. House. 109<sup>th</sup> Cong., 1<sup>st</sup> Sess. H.R. 1561. ONLINE. Thomas. Available: <http://thomas.loc.gov> [11 May 2005].

tax policy are understood and intended, especially with respect to low-income taxpayers.

Taxpayers who do not know much about the credit and its qualifications and limitations may find themselves making adoption and adoption cost decisions based on misinformation, only to find out later that they cannot fully utilize the credit as they had anticipated. The loss in utility can be an actual loss in the dollar amount of the credit utilized or may simply be a loss due to the time value of money if the credit provides tax benefits over an extended period of time. Ironically, it may be the “positive” features of the credit that make it so easy to misunderstand. It is unusual in that it is a 100% credit and it has a very high dollar limit as far as personal tax credits go.<sup>39</sup> These “positive” features of this nonrefundable credit make it more likely that some of the benefit will be lost to low-income taxpayers. However, because the adoption tax credit will not be claimed by a very large percentage of taxpayers, the implications of these positive features are not well publicized.<sup>40</sup> In addition, the implications are not well understood by potential adoptive parents, adoption agencies, or even professional tax preparers, especially not before the adoption decisions are made and the costs committed.

The discussion should continue to consider if the possible outcomes for low-income taxpayers are either intended by the legislation and/or if they are appropriate. That discussion could potentially lead to further refinements of the credit. However, the larger purpose of this paper is to build recognition for the complexity of this tax credit and help to educate those who are involved, either as adoptive parents, potential adoptive parents, professional tax preparers and consultants, adoption agencies,

---

<sup>39</sup> It is also unusual in the sense that some adoption expenses may be reimbursed by an employer and qualify for the adoption tax exclusion. Very few credits have corresponding exclusions. It is even rarer that both the credit and a related exclusion can potentially be claimed for the same event (although it is true that they cannot be claimed for the same expense).

<sup>40</sup> Tax credits such as the child tax credit or the education credits which apply to a larger percentage of taxpayers are more likely to get the publicity and therefore be better understood by taxpayers and tax professionals.

and/or adoption advocates. An increased understanding of the implications of this credit for low-income taxpayers will help better, more informed decisions to follow.