

**ADOPTION TAX BENEFITS:  
EMPHASIZING THE EXCLUSION BEFORE THE CREDIT**

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**ABSTRACT**

This paper reviews the qualifications and limitations on the adoption tax credit and exclusion. It also details the complications in coordinating the exclusion and the credit. The paper discusses reasons why tax policy should encourage greater business participation through employer adoption assistance programs. It then proposes tax policy which would make employer reimbursement (with the exclusion), rather than the adoption tax credit, the primary tax benefit for many adoptions, at least for adoptive parents whose employers offer adoption assistance programs. The results could include (1) greatly reduced complication in coordinating the available tax benefits, (2) lower governmental costs for adoption tax benefits, (3) more participation by businesses in offering employee adoption assistance programs, (4) less complication in tax return preparation for adoptive parents, and (5) an earlier availability of the adoption benefits in many cases.

**KEY WORDS:** Adoption tax benefits, adoption tax credit, adoption tax exclusion, tax policy

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## INTRODUCTION

A law enacted in 1996 provided for possible adoption tax benefits for adoptive parents.<sup>1</sup> That law was expanded and extended by 2001 legislation.<sup>2</sup> The current law provides for an adoption tax credit for up to \$10,390 of unreimbursed adoption expense. In addition, an exclusion from income of up to \$10,390 is available for adoption expenses reimbursed by an employer through an adoption assistance program.<sup>3</sup> Sections of the tax code authorize the adoption tax credit<sup>4</sup> and the exclusion.<sup>5</sup> Related qualifications and limitations for these benefits are detailed in IRS documents<sup>6</sup> and are discussed by Smith.<sup>7</sup> Other papers have

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

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

<sup>3</sup> The 2001 legislation increased these amounts from \$5,000 to \$10,000. The 2001 legislation also provided for indexing of these amounts starting in 2003; the dollar limit for both the credit and the exclusion is \$10,390 for 2004. It is possible that adoption agency fees, legal fees, and other adoption costs will simply increase because of the increase in possible adoption tax benefits. If so, the tax benefits might go to adoption agencies, lawyers, and others involved in the adoption process rather than to the adoptive parents. This is an empirical issue not addressed here.

<sup>4</sup> I.R.C. § 23.

<sup>5</sup> I.R.C. § 137.

<sup>6</sup> I.R.S. Notice 97-9, 1997-2 IRB 35; I.R.S. Publication 968.

<sup>7</sup> Sheldon R. Smith, *Tax Benefits for Adoption*, Tax Notes, May 13, 2002, 1065-1071; Sheldon R. Smith, *The Adoption Tax Credit: Implications for Low-Income Taxpayers*, Proceedings, Decision Sciences Institute Annual Meeting, November 2002.

examined the technical details, presented ironies and complications of the tax benefit legislation, or provided policy suggestions.<sup>8</sup>

This paper discusses reasons why the exclusion should be changed to encourage businesses to provide employee adoption benefits, thus reducing taxpayer reliance on the adoption tax credit. This paper extends and expands prior tax policy suggestions that would reduce the complication of coordinating the adoption exclusion and tax credit and which would help an adoptive taxpayer prefer an employer reimbursement (and exclusion) to the tax credit where there is a choice between the two.<sup>9</sup> In essence, the tax policy proposed would make employer reimbursement (with the exclusion), rather than the adoption tax credit, the primary tax benefit for many adoptions, at least for adoptive parents whose employers offer adoption assistance programs. The results could include (1) greatly reduced complication in coordinating the available tax benefits, (2) lower governmental costs for adoption tax benefits, (3) more participation by businesses in offering employee adoption assistance programs, (4) less complication in tax return preparation for adoptive parents, and (5) an earlier availability of the adoption benefits in many cases.

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<sup>8</sup> Sheldon R. Smith, *The Adoption Tax Credit and Exclusion: Policy Considerations and Behavioral Implications*, Proceedings, American Society of Business and Behavioral Sciences 7<sup>th</sup> Annual Meeting, February 2000; Sheldon R. Smith, *Adoption Tax Benefits: Policy Considerations*, Tax Notes, May 14, 2001, 1159-1166; Sheldon R. Smith and Glade K. Tew, *Ironies of the Adoption Tax Credit*, Tax Notes, October 4, 1999, 83-89; Sheldon R. Smith and Glade K. Tew, *The Tax Exclusion for Employer Adoption Assistance Payments: Implications for the Employer and the Employee*, Proceedings, Decision Sciences Institute Annual Meeting, November 1999, 42-44; Sheldon R. Smith and Glade K. Tew, *The Adoption Exclusion: Complications for Employees*, Tax Notes, January 29, 2001, 659-664.

<sup>9</sup> Sheldon R. Smith, *The Adoption Tax Credit and Exclusion: Policy Considerations and Behavioral Implications*, Proceedings, American Society of Business and Behavioral Sciences 7<sup>th</sup> Annual Meeting, February 2000; Sheldon R. Smith, *Adoption Tax Benefits: Policy Considerations*, Tax Notes, May 14, 2001, 1159-1166.

## BACKGROUND

In the United States, “the total number of adoptions each year has not been comprehensively compiled since 1992. While there are reporting mechanisms for foster care and international adoptions, states are not legally required to record the number of private, domestic adoptions.”<sup>10</sup> The compilation for 1992 reported about 127,000 adoptions, approximately 42% of which were stepparent adoptions.<sup>11</sup> Other research has reported “dramatic fluctuations in the annual number of adoptions” over the last several decades,<sup>12</sup> but the number of adoptions annually had been steady through the early 1990s.<sup>13</sup> Estimates of international adoptions are more readily available by looking at the number of visas issued for such purposes. These numbers increased steadily from 6,472 in 1992 to 21,100 in 2002.<sup>14</sup>

The U.S. Department of the Treasury was required to report to Congress on the effect on adoptions of the tax credit and exclusion. The report, issued in October 2000, provided some data for the number of adoptions in 1997 and 1998 for which either of these adoption tax benefits were claimed. The number of adoptions reported on tax returns for 1997 was 40,755. Of these, 11,632 (28.5%) were adoptions of foreign children. The number of adoptions reported on tax returns for 1998 was 50,353. Of

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<sup>10</sup> Evan B. Donaldson Adoption Institute, Overview of Adoption in the United States, accessed October 2, 2003 at [http://www.adoptioninstitute.org/FactOverview\\_print.html](http://www.adoptioninstitute.org/FactOverview_print.html).

<sup>11</sup> Victor Eugene Flango and Carol R. Flango, How Many Children Were Adopted in 1992, *Child Welfare*, September/October 1995, 1018-1032. Note that costs for stepparent adoptions are nonqualifying expenses for the adoption tax benefits. See I.R.S. Publication 968.

<sup>12</sup> Evan B. Donaldson Adoption Institute, Overview of Adoption in the United States, accessed October 2, 2003 at [http://www.adoptioninstitute.org/FactOverview\\_print.html](http://www.adoptioninstitute.org/FactOverview_print.html).

<sup>13</sup> National Adoption Information Clearinghouse, Adoption: Numbers and Trends, accessed October 2, 2003 at [http://naic.acf.hhs.gov/pubs/s\\_number.cfm](http://naic.acf.hhs.gov/pubs/s_number.cfm).

<sup>14</sup> Holt International, International Adoption Statistics, accessed October 2, 2003 at <http://www.holtintl.org/insstats.shtml>.

these, 14,264 (28.3%) were adoptions of foreign children.<sup>15</sup> However, these data are not sufficient to determine a long-term trend in number of adoptions after the adoption tax benefits were legislated.

The costs of adopting vary by type of adoption and agency involvement. The National Adoption Information Clearinghouse reports that domestic public agency adoption costs range from \$0 to \$2,500, that domestic private agency adoption costs range from \$4,000 to \$30,000+, that domestic independent adoption costs range from \$8,000 to \$30,000+, and that intercountry private agency or independent adoption costs range from \$7,000 to \$25,000 (with significant additional costs possible not included in the fees).<sup>16</sup>

A taxpayer can potentially claim both the adoption exclusion and the adoption tax credit for a single adoption—the exclusion for employer-reimbursed adoption costs and the credit for unreimbursed expenses. Therefore, an adoptive taxpayer whose employer will reimburse some amount of adoption expenses can potentially end up with both the tax-advantaged employer reimbursement and up to \$10,390 of tax credit for a single adoption. Some adoptions cost more than the sum of the \$10,390 limit on the credit plus any amount the employer is willing to reimburse. For these adoptions, the adoptive taxpayers would want to claim as much employer reimbursement/exclusion (up to \$10,390) as possible and as much credit as possible. However, for adoptions where the total cost is less than the potential \$10,390 credit plus what an employer is willing to reimburse, adoptive taxpayers are left with a choice as to how much reimbursement/exclusion to claim and how much credit to claim.

Although the tax code sometimes allows a choice between a deduction and a credit for items such as foreign taxes paid, such

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<sup>15</sup> U.S. Department of the Treasury, Report to The Congress on Tax Benefits for Adoption, October 2000, available at <http://www.ustreas.gov/offices/tax-policy/library/adoption.pdf>.

<sup>16</sup> National Adoption Information Clearinghouse, Cost of Adoption, accessed October 2, 2003 at [http://www.naic.acf.hhs.gov/pubs/s\\_cost.cfm](http://www.naic.acf.hhs.gov/pubs/s_cost.cfm).

a choice is unusual. It is also unusual when a taxpayer has a choice between an exclusion and a credit as can be the case with adoption tax benefits. The focus of this paper is on adoptions where there may be a choice for the adoptive taxpayer, at least for part of the adoption cost, to claim the employer reimbursement (and exclusion) or to claim the credit.<sup>17</sup> The reason for this focus is that these situations afford the most compelling policy arguments.

The next section reviews some of the qualifications and limitations on the credit and exclusion. It is followed by a review of prior papers which illustrate the potential complications for adoptive employees who are faced with a choice between the reimbursement/exclusion and the credit. Two additional sections then follow—one which gives reasons why future adoption tax benefit legislation should encourage an increase in adoption benefits provided by businesses and another which indicates how this might be accomplished. Those sections are followed by a conclusion.

## **REVIEW OF QUALIFICATIONS/LIMITATIONS FOR THE CREDIT AND EXCLUSION**

IRS publications and an article by Smith outline the features and limitations of the adoption tax credit and the exclusion.<sup>18</sup> The types of qualifications and limitations that exist will be mentioned, but only those which are most relevant to this paper will be explained.

### **Qualifications**

Expenses must be qualified adoption expenses (QAE) to be eligible for either the credit or the exclusion. The child adopted

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<sup>17</sup> See Smith, Sheldon R., "Coordinating Adoption Tax Benefits: Is There a Choice?," *Journal of Accounting, Ethics & Public Policy*, forthcoming, for a discussion of why the choice between the credit and the exclusion really does exist despite some arguments to the contrary.

<sup>18</sup> I.R.S. Notice 97-9, 1997-2 IRB 35; I.R.S. Publication 968; Sheldon R. Smith, *Tax Benefits for Adoption*, Tax Notes, May 13, 2002, 1065-1071.

must meet the definition of an eligible child. Additional requirements must be met for the child to qualify as a child with special needs, including the provision that a foreign child cannot qualify as a child with special needs.<sup>19</sup> To be eligible for the exclusion, any employer-reimbursed amounts must be paid under an adoption assistance program which meets certain requirements.<sup>20</sup>

The timing of the credit and exclusion depend on whether a domestic or foreign child is adopted. Foreign adoptions are the not focus of this paper,<sup>21</sup> so only the timing rules for a domestic adoption will be detailed. The credit can be claimed in the year the expense is paid if the adoption is finalized that year or has previously been finalized. If the adoption has not yet been finalized, the credit can be claimed in the year following the year the expense is paid. The exclusion can be claimed in the year the

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<sup>19</sup> The 2001 law provides for different rules for the adoption of children with special needs. After 2002, parents who adopt a child with special needs can take an “automatic” \$10,390 (for 2004) credit, regardless of expenses incurred. In addition, employers can reimburse up to \$10,390 (for 2004) for such adoptions with all of it being excludable to the recipient(s), regardless of expenses incurred. Since these benefits are not based on expenses incurred, the complications in coordinating the credit and exclusion addressed in this paper do not apply. Therefore, adoptions of children with special needs will not be specifically discussed here.

<sup>20</sup> I.R.S. Publication 968.

<sup>21</sup> The rules on claiming the adoption credit and exclusion are more restrictive for adoptions of foreign children. For the adoption of a foreign child, the tax benefits are only available if and when the adoption is finalized (I.R.S. Publication 968), perhaps because the legislation is aimed more at providing permanent homes for domestic children in foster care and reducing government foster care and welfare costs than it is at encouraging foreign adoptions. Therefore, in most cases, the coordination of the credit and exclusion for adoptions of foreign children will be less complicated (although the adoption itself can be much more complicated), because both tax benefits become available in the same year for all costs incurred up through the year of finalization. Whether this additional restriction for foreign adoptions is appropriate is a policy issue not addressed in this paper.

employer pays or reimburses the adoption cost.<sup>22</sup>

Taxpayers who adopt multiple children can potentially claim multiple credits and/or exclusions. For domestic adoptions, a credit can still be claimed for an unsuccessful adoption attempt. If an employer is willing to reimburse expenses of unsuccessful domestic adoptions, the exclusion is also available. However, unsuccessful adoption attempts must be grouped together (with or without a successful attempt) into one adoption effort, and only one credit and/or exclusion is available per adoption effort.<sup>23</sup>

### **Limitations**

Two specific limitations apply to both the credit and the exclusion. A third limitation applies only to the credit. The first limitation is the limitation on the amount of credit and/or exclusion. As has been mentioned, the credit and exclusion are limited to \$10,390 per adoption. The second limitation is an income limitation. The credit and exclusion are phased out proportionately for taxpayers whose modified adjusted gross income (AGI) is between \$155,860 and \$195,860.<sup>24</sup> Modified AGI for purposes of the credit is slightly different than for purposes of the exclusion. For the exclusion, modified AGI includes any employer reimbursement of adoption expenses. For the credit, only that portion of an employer reimbursement which is not excludable is included in modified AGI.<sup>25</sup>

The third limitation on the credit is that it cannot reduce the tax liability, including the regular tax and the alternative minimum tax, below zero. In other words, the credit is nonrefundable. Although the credit is nonrefundable, any unused portion can be carried forward up to five years beyond the initial year of the credit.<sup>26</sup>

Even though no federal income tax will be due on amounts

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<sup>22</sup> I.R.S. Publication 968.

<sup>23</sup> I.R.S. Notice 97-9, 1997-2 IRB 35.

<sup>24</sup> Rev. Proc. 2003-85. These are the 2004 inflation-adjusted amounts.

<sup>25</sup> I.R.S. Publication 968.

<sup>26</sup> I.R.S. Publication 968.

that qualify for the exclusion, these employer reimbursements are still subject to the employee and/or employer portions of social security, Medicare, and unemployment taxes.<sup>27</sup> They may also be subject to state income taxes if not specifically excludable by state law.

Because of the qualifications and limitations on claiming the adoption tax credit and exclusion, complications can arise when a taxpayer has to make a choice as to which to claim—the employer reimbursement (and exclusion) or the credit.

### **COMPLICATIONS IN COORDINATING THE EXCLUSION AND THE CREDIT**

The adoption tax credit gives the taxpayer a dollar-for-dollar benefit, whereas an employer reimbursement and exclusion does not because of the stipulation that employer reimbursements are subject to social security and Medicare taxes. Employer reimbursements may also be subject to state income taxes if the state does not provide the same exclusion provided by the federal tax laws. In situations where the exclusion is not available (for at least part of the reimbursement), the reimbursements are also subject to federal income taxes.

The timing of the credit and exclusion are also different. In some cases, a long time is required for the adoption to occur and be finalized. If adoption expenses are paid early on in this process, these expenses can become eligible for the credit in the year following payment. If the adoption has not been finalized by the end of that following year and no employer reimbursement is available until finalization, the credit may actually be available before the exclusion. Even so, a taxpayer might want to determine when he/she will get the benefit of the credit if he/she will need to carry some of it forward to future years.<sup>28</sup>

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<sup>27</sup> I.R.S. Notice 97-9, 1997-2 IRB 35.

<sup>28</sup> Sheldon R. Smith and Glade K. Tew, *The Adoption Exclusion: Complications for Employees*, Tax Notes, January 29, 2001, 659-664.

In many other situations, the employer reimbursement and exclusion are available before the credit. For example, this can occur when adoption expenses are paid, an adoption is finalized, and employer reimbursement is received all in the same year. In this case, the reimbursement can come before the credit. “The credit might not be available for a longer period of time because of the possible lag between the expense and when it can be claimed for the credit, the lag in claiming a credit only when the prior year’s tax return is filed, or the lag due to a carryforward of unused credit to future tax years.”<sup>29</sup> Although it is possible to “claim” the credit prior to the filing of the annual tax return through adjustments in the number of withholding exemptions, that is complicated for most taxpayers and can be risky if the adoption has not yet been finalized (even though finalization is expected).<sup>30</sup>

Table 1 illustrates some of the complications of coordinating the credit and the exclusion. It is provided mostly as an illustration of the level of complications potentially involved rather than as a decision model for maximizing the tax benefits.<sup>31</sup> This table assumes a single adoption of a domestic child who is not a child with special needs. In addition, the taxpayers’ modified AGI (with employer reimbursement) is assumed to be less than \$155,860 (to avoid the complications of the income phase-out range).

Previously, employer adoption reimbursements above

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<sup>29</sup> Sheldon R. Smith and Glade K. Tew, *The Tax Exclusion for Employer Adoption Assistance Payments: Implications for the Employer and the Employee*, Proceedings, Decision Sciences Institute Annual Meeting, November 1999, 42-44 at 44.

<sup>30</sup> Sheldon R. Smith and Glade K. Tew, *The Adoption Exclusion: Complications for Employees*, Tax Notes, January 29, 2001, 659-664. As a possible policy consideration, the risk would be reduced or eliminated if the credit were allowed in the year of payment for qualifying expenses paid in a year before the year the adoption becomes final.

<sup>31</sup> Although the table, as it appears, could be used as an unsophisticated decision model, the desired focus is the potential complications which become apparent in each table cell as one contemplates all of the variables, known and unknown that could affect the timing of the credit and exclusion.

\$5,000 were not very likely, perhaps because the exclusion amount up through 2001 was only \$5,000.<sup>32</sup> An employer reimbursement above \$10,390 would be very unlikely because some of it would not be excludable to the employee and because of the large dollar amount involved.<sup>33</sup> Therefore, the first row of Table 1 is the most relevant. However, the second row has been added for completeness.

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<sup>32</sup> The U.S. Department of the Treasury Report to The Congress on Tax Benefits for Adoption (October 2000) reported an average employer reimbursement per adoption (based on tax return data) for 1997 of \$2,425 and for 1998 of \$2,510. The percentage of tax returns which had reimbursements under \$5,000 was 87% for 1997 and 86% for 1998. The percentage of tax returns which had reimbursements under \$6,000 was 95% for 1997 and 96% for 1998. In addition, the National Adoption Center surveys companies/organizations (including for-profit, not-for-profit, and governmental entities) to determine what adoption-related employee benefits are offered. Although the survey is not based on a scientific sample, it is informative. The most recent information available through this survey indicates that 94.4% of the 426 entities that offer adoption reimbursements offer a benefit of \$5,000 or less (telephone interview with Lucy Belcastro of the National Adoption Center, October 8, 2003).

<sup>33</sup> The U.S. Department of the Treasury Report to The Congress on Tax Benefits for Adoption (October 2000) reported that the number of tax returns which reported employer reimbursements in excess of \$10,000 was 1% for both 1997 and 1998. The National Adoption Center survey reports only 2 entities (0.5% of the 426 reporting adoption reimbursements) that offer an adoption reimbursement above \$10,160, the 2003 dollar limit, and another 9 entities (2.1%) that offer an adoption reimbursement of \$10,000 (telephone interview with Lucy Belcastro of the National Adoption Center, October 8, 2003).

**Table 1**  
**Complications in Coordinating Employer Adoption**  
**Reimbursement/Exclusion with the Adoption Tax Credit**  
**Single Adoption of a Domestic Child without Special Needs**  
**Taxpayer Modified AGI < \$155,860 (including any employer**  
**reimbursement)**

		Amount of Qualified Adoption Expenses (QAE)		
		\$0 - \$10,390	\$10,390 - \$20,780	> \$20,780
Maximum Amount Reimbursable by		Cell 1: Compare the timing of the credit and exclusion with the extra costs of the exclusion (social security, Medicare, and any state income taxes); Take the reimbursement if it is more valuable up to the maximum amount the employer will pay or the QAE, whichever is less; Take the credit for any unreimbursed amount	Cell 2: Take the reimbursement for at least any amount available above \$10,390 of cost; Compare timing of credit and exclusion with the extra costs of the exclusion to determine whether to take additional reimbursement, if available; Take the credit for any unreimbursed amount	Cell 3: Take as much reimbursement as possible. Take the maximum \$10,390 credit. No coordination is needed with respect to amounts. However, the question of which expenses to have reimbursed and which to use for the credit may still be an issue—timing may still make a difference
	\$0 - \$10,390			

	> \$10,390 (very unlikely)	<p>Cell 4: Compare the timing of the credit and exclusion with the extra costs of the exclusion (social security, Medicare, and any state income taxes); Take the reimbursement if it is more valuable up to the amount of the QAE; Take the credit for any unreimbursed amount</p>	<p>Cell 5: Take the reimbursement for at least any amount above \$10,390 of cost; Compare timing of credit and exclusion with the extra costs of the exclusion to determine whether to take additional reimbursement (since any amount reimbursed above \$10,390 is not excludable, the “extra cost” on this portion now includes federal income taxes); Take the credit for any unreimbursed amount</p>	<p>Cell 6: Take the reimbursement for at least any amount above \$10,390 of cost, recognizing that any reimbursement above \$10,390 will not be excludable; Compare timing of credit and exclusion with the extra cost of the exclusion to determine whether to take additional reimbursement (since any amount reimbursed above \$10,390 is not excludable, the “extra cost” now includes federal income taxes); Take the credit for any unreimbursed amount</p>
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An example for Cell 1 from Table 1 would be a couple who incurred qualified adoption expenses (QAE) of \$7,500 and where one of the spouses had an employer willing to reimburse up to \$3,000 of adoption costs. The taxpayers should compare the timing of the reimbursement/exclusion with the timing of the credit. Obviously, if the credit is available first, the entire \$7,500 should be taken as a credit. If the reimbursement/exclusion is available first, the “extra cost” of the exclusion (the social security and Medicare taxes and perhaps state income taxes) would need to be compared with the timing of the credit. For some couples, the credit might still be a better option even though it is available later. For other couples, the reimbursement might be a better option even though a lower net amount would be received, especially if the credit would need to be claimed over multiple years or if some of it

would expire before being used. Certainly the taxpayer would claim the credit for any amount not reimbursed by the employer—in this case, at least \$4,500 and perhaps more.

An example for Cell 2 from Table 1 would be a couple who incurred QAE of \$13,000 and where one of the spouses had an employer willing to reimburse up to \$4,000 of adoption costs. This couple would want to claim an employer reimbursement for at least \$2,610 because the credit cannot be claimed for more than the other \$10,390. In addition, this couple would then need to determine, based on timing and “extra cost” issues, whether to claim any additional reimbursement from the employer or to take the credit for the difference. Because of the uncertainty of adoption finalization and the timing of adoption expenses, trying to compare the timing of the credit and exclusion may be difficult, even for a finalized adoption. For adoptions that are still in progress, determining the future timing of the exclusion and the credit will be even more difficult, if not impossible.

If a couple spends more than \$20,780 on QAE and can be reimbursed by an employer for any amount up to \$10,390, the situation is described in Cell 3 of Table 1. In these cases, the taxpayers would want to claim the full reimbursement possible and claim a \$10,390 adoption tax credit. No coordination is needed as to what amount of each benefit to claim. However, timing could still be a factor, especially if employer reimbursement is offered before finalization—the taxpayers may still need to determine which expenses to have reimbursed and which to claim for the credit.

Although unlikely to occur, the situations in Cells 4, 5, and 6 from Table 1 can be even more complicated. In these situations, the employer offers a reimbursement above \$10,390. Any amount reimbursed above \$10,390 would not qualify for the exclusion. Therefore, when comparing the timing differences with the “extra cost,” the “extra cost” would then include federal income taxes on any portion above \$10,390 of reimbursement. However, a reimbursement above \$10,390 would still be desirable if there were \$21,000 of adoption expenses and up to \$12,000 of

reimbursement available. The adoptive couple would want to claim a reimbursement for at least \$10,610 (any amount above \$10,390 of costs that would be potentially eligible for the credit). Even though part of the \$10,610 would not be excludable, a taxable employer reimbursement is better than no reimbursement or tax credit. Whether the adoptive couple would claim more than \$10,610 in reimbursement would again depend on the tradeoff of the timing issues with the extra costs (including federal taxes) for the exclusion.

The complications illustrated in Table 1 can increase dramatically if any of the following is assumed: multiple adoptions, taxpayer modified AGI in the phase-out range, an "exclusion operated through a spending account option funded by either the employer or the employee."<sup>34</sup> There is a lot of uncertainty surrounding an adoption attempt, the required expenses and the timing of those expenses, and the outcome of that attempt. This uncertainty adds even further complexity, perhaps beyond the ability of the best tax planning efforts.

The simplified situations in Table 1 illustrate that, even for the least complex situations, optimal coordination of these adoption tax benefits may not fit within an orderly decision model framework. Even if a taxpayer knows which cell he/she is in or will be in, the choice can be complicated. However, taxpayers may be eligible for some adoption tax benefits even before knowing which cell they will be in. In these cases, the taxpayers may have even less information with which to make decisions about possible tradeoffs between the exclusion and the credit. Any appropriately realistic quantitative decision model for coordinating adoption tax benefits would be so complicated as to make its practicality to adoptive parents questionable at best. The next two sections discuss why tax policy should encourage greater business participation in adoption benefits and how legislation might accomplish this. Among the benefits of the proposed policy would

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<sup>34</sup> Sheldon R. Smith and Glade K. Tew, *The Adoption Exclusion: Complications for Employees*, Tax Notes, January 29, 2001, 659-664 at 664.

be a great reduction in the complication in coordinating the two adoption tax benefits.

### **WHY SHOULD TAX POLICY ENCOURAGE GREATER BUSINESS PARTICIPATION?**

The government has provided a way to encourage businesses to support adoption efforts by providing an exclusion for reimbursements of adoption expenses paid through an adoption assistance program. Certainly businesses are more likely to provide employee benefits if the cost of providing the benefit is both deductible to the business and excludable for the employee as is the case with adoption benefits meeting the qualifications in I.R.C. § 137. Several reasons exist as to why tax policy should encourage even greater participation.

It is certainly expected that government welfare and foster care costs are reduced by supporting adoption. This is one argument for providing any type of adoption tax benefits. However, it is less costly to the government to provide a tax exclusion than a tax credit of an equal amount. Encouraging greater business participation in reimbursing adoption expenses through more liberal exclusion policies could reduce the overall cost to the government.<sup>35</sup> Even with encouragement, not all employers can or will provide adoption benefits, so the adoption tax credit can still be a valuable tax benefit, either as the only adoption tax benefit for taxpayers whose employers offer no adoption assistance program or as a secondary benefit beyond the exclusion.

Socially conscious companies may be willing to provide some adoption benefits (or increased adoption benefits), especially with government encouragement through tax policy. In addition, companies with existing health insurance plans that already provide maternity benefits for employees may also desire to provide an adoption benefit plan for employees who adopt rather

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<sup>35</sup> Sheldon R. Smith, *Adoption Tax Benefits: Policy Considerations*, Tax Notes, May 14, 2001, 1159-1166.

than use the maternity benefit, especially if that benefit can be tax advantaged.<sup>36</sup>

Actual receipt of the adoption benefit is likely easier through an employer than through a complicated tax form. Although both types of payment will require documentation, it will likely be easier for an employee to get the reimbursement from his/her employer than through a tax credit. Because of the requirements of the current law, Form 8839 must be completed to see how much of the employer reimbursement is excludable. If no tax form had to be completed, the relative ease of the reimbursement would increase.

The exclusion is less likely to be subject to fraud than is the credit. Although adoption expenses should be documented for either adoption tax benefit, an IRS audit may be the only way to catch fraud with respect to the credit. Since the employer will require documentation before reimbursing adoption costs, the exclusion has that third-party verification and reporting mechanism as an additional fraud deterrent. In addition, the employee may be closer/more loyal to the employer and less likely to try to defraud the employer. The employer is also more likely to know the personal situation for the employee to know if, in fact, an adoption is in process or complete.

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<sup>36</sup> Sheldon R. Smith, *Adoption Tax Benefits: Policy Considerations*, Tax Notes, May 14, 2001, 1159-1166. As a counter argument, the author is aware of a multi-employer benefit company that has decided to eliminate its adoption assistance plan beginning in 2003 because it was originally intended to provide a benefit similar to the maternity benefit in the employers' insurance plan. Since the adoption tax credit has been created and expanded, most of the employees who adopt will be able to get an adoption tax credit approximately equivalent to or greater than the maternity benefit offered through the insurance plan. Many of the employers affiliated with this particular benefit company are non-profit entities. Therefore, the direction from these employers to the benefit company is to provide competitive benefits but not to set a new, higher standard of benefits. As a side note, since many of the employers serviced by this benefit company are non-profit, tax-exempt entities, there is no tax advantage to the entity paying the benefit since there is no tax return on which to deduct these employee benefits.

For some low-income taxpayers, the benefit of the adoption tax credit may be partially or wholly lost because it is nonrefundable.<sup>37</sup> In addition, taxpayers that already have larger families with more dependency exemptions before adopting a child may have lower tax liabilities, making it more difficult to use the adoption tax credit. In some of these cases, a possible employer reimbursement with the exclusion may be the only adoption benefit the adoptive taxpayers can use, thus making the exclusion even more important to this group of taxpayers.

As mentioned earlier, although it is possible that the adoption tax credit can be available before an employer reimbursement in certain cases, it is often the case that the benefit of the credit would come much later than the benefit of the employer reimbursement. Since the employer reimbursement is often available to the taxpayer earlier, it seems reasonable to increase the incentive for employers to provide adoption assistance, benefitting both the adoptive employee and the government.

### **HOW MIGHT LEGISLATION ENCOURAGE GREATER BUSINESS PARTICIPATION?**

Suggestions have been given in prior papers to make the exclusion easier to coordinate with the credit.<sup>38</sup> Most of these suggestions have involved a liberalization of the qualifications and limitations associated with the exclusion such that the exclusion would also provide a dollar-for-dollar benefit like the credit does. That way, taxpayers would not need to worry about taking an employer reimbursement and then wishing later that they had not

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<sup>37</sup> Sheldon R. Smith, *The Adoption Tax Credit: Implications for Low-Income Taxpayers*, Proceedings, Decision Sciences Institute Annual Meeting, November 2002.

<sup>38</sup> Sheldon R. Smith, *The Adoption Tax Credit and Exclusion: Policy Considerations and Behavioral Implications*, Proceedings, American Society of Business and Behavioral Sciences 7<sup>th</sup> Annual Meeting, February 2000; Sheldon R. Smith, *Adoption Tax Benefits: Policy Considerations*, Tax Notes, May 14, 2001, 1159-1166.

done so. These suggestions included: (1) extending the exclusion law so that employer adoption reimbursements would not be subject to social security, Medicare, or unemployment taxes (and encouraging states to also honor the exclusion), (2) increasing the income phase-out range, (3) increasing the dollar limit on the excludable amount, and (4) restructuring the phase-out of the exclusion to match more closely the exclusion for gain on the sale of a home.<sup>39</sup> These suggestions were made before passage of the 2001 law which extended and expanded the adoption tax credit and the related exclusion. The 2001 law did increase the income phase-out range and the dollar limit on the exclusion to the amounts given earlier in this paper.

This paper expands on a suggestion from that earlier paper, combining the need for four possible suggestions into one proposal. Employer adoption reimbursements should be treated as are medical insurance payments/reimbursements, and this treatment should be legislated on a permanent basis.<sup>40</sup> Medical insurance reimbursements have no tax consequence to the recipient, either in the form of income taxes or in the form of social security or Medicare taxes. From the employer's perspective, these payments have no additional costs for social security, Medicare, or unemployment taxes. No income limits exist for medical expense reimbursements, nor should they for

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<sup>39</sup> Sheldon R. Smith, *Adoption Tax Benefits: Policy Considerations*, Tax Notes, May 14, 2001, 1159-1166. For specific information on suggestion #4, see the referenced article, including footnote 12, for an explanation of how the exclusion is phased out and how that compares to the phase-out for excluding the gain on the sale of a home.

<sup>40</sup>Since the extended/expanded adoption tax benefit legislation in 2001 was part of the Economic Growth and Tax Relief Reconciliation Act which sunsets after 2010, making a new law permanent would overcome the concern of a possible reversal of the benefits after 2010. H.R. 1057 was passed by the House of Representatives on September 23, 2004 with a 414-0 vote. This bill would repeal the sunset of the Economic Growth and Tax Relief Reconciliation Act with respect to the expansion of the adoption tax credit and exclusion. The Bush administration supports the bill, but the Senate has not yet acted, so the outcome is not final.

adoption reimbursements. No dollar limit exists for the excludability of medical insurance reimbursements, nor should one exist for adoption reimbursements. However, the terms of the exclusion should continue to require the appropriate substantiation of qualified expenses for the adoption of an eligible child.

This proposal could result in several positive effects:

1. The complexity and complication of coordinating the exclusion and the credit would be eliminated or at least reduced.<sup>41</sup> In cases where the credit was available first, it could be taken, but in cases where the employer reimbursement/exclusion was available first, it could be taken without worry of adverse consequences.
2. The permanency of the exclusion would allow employers to determine the best long-term adoption assistance plan for their company culture and financial resources. This stability in employee benefit plans could reduce the uncertainty surrounding adoption costs and reimbursements.
3. Employers who are not providing adoption benefits may be encouraged to provide some level of benefit. Employers who already provide adoption benefits may be encouraged to consider improving those benefits. Since this proposal would treat adoption reimbursements similar to insurance reimbursements, employers might more easily determine what level of adoption benefit might be fair compared to the level of maternity benefits offered by the company's

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<sup>41</sup> In some, likely rare, cases where the adoption process is very long and significant expenses are incurred early in the process, the credit might be available much earlier than the reimbursement/exclusion. If the credit is claimed on a tax return but really provides no or only limited actual tax benefit because of a zero or low tax liability, it is possible that a reimbursement/exclusion later would end up having been the preferred adoption tax benefit. In some of these cases, an amended return for the year the credit was originally claimed might be filed (if it is still within the time frame to be amendable) to eliminate the claim for the credit so the reimbursement/exclusion could be taken.

insurance program. Employers may be more willing to provide benefits if there is no additional cost for social security, Medicare, and unemployment taxes and if the employees would also be exempt from the employee portions of these taxes.

4. Currently, any portion of the employer reimbursement that is not excludable becomes part of the modified AGI, thus reducing the available credit for those in the income phase-out range. Under this proposal, no employer reimbursement would be included in income, so a taxpayer would not need to worry about the employer reimbursement affecting the amount of credit that can be claimed, at least in terms of income limits (the credit would still not be available for any expense that was reimbursed, so the employer reimbursement might affect the amount of credit available, but only in terms of the adoption expenses incurred, not in terms of income limits).
5. Currently, any portion of the employer reimbursement that is not excludable becomes part of the taxpayers' AGI. Some of the itemized deductions are limited based on AGI. For example, only medical and dental expenses in excess of 7½ percent of AGI are allowed as itemized deductions. Miscellaneous deductions in excess of 2 percent of AGI are the only portion included in itemized deduction calculations. This proposal would eliminate the need to worry about these limits with respect to employer adoption benefits, because the adoption benefits would not affect AGI.
6. No tax form would need to be filled out by the adoptive parent taxpayers to calculate the amount excludable. This would greatly simplify the tax reporting requirements and procedures for adoptive parents. Perhaps employer reimbursements would still need to be reported on the W-2 forms to provide information to the IRS that would help verify other expenses claimed for the adoption tax credit.

Some possible concerns with this proposal might be the lack of dollar and income limits on the exclusion and the loss of government revenues for some of the taxes that would no longer be collected on these amounts. The lack of a dollar limit on the exclusion would not likely be a large problem. Companies would have policies based on common sense and some type of equity. Rational managers will not attempt to unreasonably enrich adoptive parent employees at the expense of other employees or the owners. Some companies would have better adoption assistance plans than others, but this is currently true as well. Companies often compare their benefit plans with other companies' plans to make sure they are offering "comparable" benefits, so it is unlikely any one company will begin to offer an extremely high adoption benefit compared to other companies.

The lack of an income limit might mean an exclusion for additional taxpayers who do not now qualify for the current exclusion. However, this exclusion would simply be consistent with the exclusion for medical expense reimbursements from an insurance company.

Although some government revenues would be lost if social security, Medicare, and unemployment taxes were not applicable to these reimbursements, the impact might not be too great. The wage base for unemployment taxes is \$7,000 per year. Most employees who would qualify for a major employee benefit such as adoption reimbursement would already be earning in excess of \$7,000 in wages/salary, so the unemployment taxes would not likely change much. The social security tax revenues would decrease if the adoption reimbursements were not subject to this tax, but some employees might already earn the maximum wage base for the year anyway. In addition, these reimbursements would not be part of the social security wage base in calculating future benefits, so it would not be a great problem to exclude them from the tax. The Medicare tax has no maximum wage base and thus there would definitely be a loss of government revenues relating to this tax. However, these specific reimbursements could again be excluded in calculating an employee's possible Medicare

benefits. In addition, more employer reimbursement may lead to less need for the tax credit (although the credit could still be available, especially for those whose employers do not offer an adoption assistance program), so the small loss in government revenue from this proposal may be more than offset by the savings from less need for the tax credit.

### **CONCLUSION**

This paper has reviewed the current tax benefits for adoption, including the qualifications and limitations for both the adoption tax credit and the adoption exclusion. The possible complications in coordinating the credit and exclusion are mentioned and illustrated. Reasons are given why tax policy should encourage greater business participation through employer adoption assistance programs. A specific tax policy proposal is also given which extends and expands upon prior tax policy suggestions aimed at reducing the complications of coordinating the adoption exclusion with the adoption tax credit. This proposal also indicates how greater business participation in offering adoption benefits might be encouraged, thus making employer reimbursement (with the exclusion), rather than the adoption tax credit, the primary tax benefit for many adoptions.