

CONTINUING CHANGES TO THE ADOPTION TAX CREDIT AND EXCLUSION

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ABSTRACT

This paper discusses the evolution of the adoption tax credit and exclusion which were first legislated in 1996. Several changes, updates, and extensions have been legislated since then. The most recent changes to these adoption tax benefits were legislated in 2010 by the Patient Protection and Affordable Care Act. These most recent changes will be detailed. The potential reversion of the adoption tax benefits back to pre-2001 legislation levels will be mentioned. Some policy issues will also be raised.

INTRODUCTION

The adoption tax credit and exclusion were legislated by The Small Business Job Protection Act of 1996 (P.L. 104-188). These tax benefits were first available for the 1997 tax year. Features and limitations of these tax benefits were detailed by Smith and Tew (1999, 2001). The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (P.L. 107-16) expanded and extended these adoption tax benefits. The Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) provided some corrections and clarified some ambiguities raised by the 2001 legislation. Changes in the adoption tax credit and exclusion from these two pieces of legislation were discussed by Smith (2002, 2005). Other pieces of legislation have made minor changes to the adoption tax benefits. The Patient Protection and Affordable Care Act of 2010 (P.L. 111-148) provided additional changes to these tax benefits which are effective for 2010 and 2011. These changes were made because the 2001 legislation would otherwise have sunset by the end of 2010, causing the adoption tax benefits to revert to what they would have been without the 2001 legislation.

This paper will provide some of the background of these two tax benefits, including the features and limitations associated with them and how some of these features and limitations have changed over time. The effects of the most recent legislation on these tax benefits will also be discussed, as they are not insignificant. The paper will also mention what will happen to these adoption tax benefits if the 2001 tax legislation is allowed to expire as scheduled. Some policy issues will be raised briefly.

ADOPTION TAX CREDIT—1997 - 2010

The adoption tax credit was legislated in 1996, effective first in 1997. It was legislated as a credit for qualified adoption expenses. The adoption tax credit has a dollar limit. As originally legislated the limit was \$5,000 (\$6,000 for adoptions of children with special needs). This limit was in place from 1997 through 2001. In 2002 the limit was increased to \$10,000 and was indexed to increase each year. This new indexed limit also applied to adoptions of children with

special needs. However, starting in 2003, those who adopted children with special needs could take the maximum credit regardless of whether or not they incurred qualified adoption expenses.

The credit was also limited by modified adjusted gross income (MAGI). From 1997 through 2001 the credit phased out for MAGI levels between \$75,000 and \$115,000. The lower limit on this \$40,000 phaseout range was increased to \$150,000 in 2002 and was also indexed for years beyond 2002. For 2010, the phaseout range goes from \$182,520 to \$222,520.

A third limit on the credit was legislated in 1996 and kept in the 2001 changes. The adoption tax credit is a nonrefundable credit. In other words, the credit could only reduce the tax liability to zero. Because of the large dollar limit on the credit and its nonrefundable status, a carryforward of unused credit was allowed for up to five years beyond the year of the original credit.

The timing of the credit depended on when the adoption was finalized. Adoption costs paid in the year of finalization or after are eligible for the credit in the year of payment. Adoption costs incurred in a year prior to finalization are eligible for the credit in the year following payment. The timing rules are different if a foreign child is adopted. In that case, no expenses are eligible for the credit until the adoption is finalized. In 2003 when the maximum credit became available for adoptions of children with special needs regardless of whether qualified adoption expenses were incurred or not, the timing rules for these adoptions changed slightly. The credit was still available under the same timing rules for any actual adoption expenses incurred. However, any difference between the adoption expenses incurred and the maximum dollar limit became eligible for the credit in the year of finalization.

ADOPTION EXCLUSION—1997-2010

The exclusion for employer-paid adoption costs was also legislated in 1996, effective for years starting in 1997. The employer was required to have an adoption assistance plan in place, and the expenses reimbursed had to be qualified adoption expenses.

Limits similar to those which exist for the credit also exist for the exclusion. The original dollar limit on the exclusion was \$5,000 (\$6,000 for adoptions of children with special needs). This limit was in place from 1997 – 2001. As of 2002, the dollar limit was increased to \$10,000 and was indexed for years beyond that. This new indexed limit also applies to adoptions of children with special needs starting in 2002. Starting in 2003 the exclusion for adoptions of children with special needs became available regardless of qualified adoption expenses incurred. Although one might assume the exclusion would still be limited to the amount of employer payment, the IRS administratively interpreted the law such that employer payment is not required for the employee to claim the exclusion for the maximum dollar limit. One would assume the employer might pay for at least some of any actual adoption expenses incurred (up to the limit provided in the employer's adoption benefit package). However, the employee can also exclude any remainder up to the maximum dollar limit even without employer payment.

Like the credit, the exclusion is limited by MAGI. From 1997 through 2001, the exclusion phased out for MAGI levels between \$75,000 and \$115,000. The lower limit of the \$40,000 phaseout range was increased in 2002 to \$150,000 and indexed for future years. For 2010, the MAGI phaseout range for the exclusion is from \$182,520 to \$222,520.

Also like the credit, the exclusion has specific timing rules. For domestic adoptions the exclusion can be claimed in the year the employer pays the qualified adoption expenses. For foreign adoptions, no exclusion is available until the adoption is finalized. Starting in 2003 because the maximum exclusion was available for adoptions of children with special needs regardless of adoption expenses incurred, any employer payment for actual adoption expenses could be excluded in the year of payment. Then the difference between any actual adoption expenses paid by the employer and the maximum dollar limit could be excluded in the year of finalization.

2010 LEGISLATION

The tax changes passed as part of the EGTRRA were all scheduled to revert after 2010 back to the legislation in effect prior to EGTRRA. This reversion would have affected the adoption tax benefits. To avoid this reversion, the Patient Protection and Affordable Care Act of 2010 included some temporary changes to the adoption tax benefits. These changes are effective for only 2010 and 2011 as currently enacted.

The maximum adoption tax credit and exclusion for 2010 under the indexing that had been in place would have been \$12,170. The new legislation changed this amount for 2010 to \$13,170, increasing it \$1,000 above what it would have been. These dollar limits are indexed further for 2011. Thus, the 2011 dollar limit for both the credit and exclusion is \$13,360 (IRS, 2010b). As indexed, the MAGI phaseout range for both adoption tax benefits for 2011 is from \$185,210 to \$225,210.

Perhaps the more significant result of this legislation is that for 2010 and 2011, the adoption tax credit has become refundable. This means that taxpayers will no longer have to carry forward unused amounts of the credit to future years because all amounts which qualify for the credit will provide an immediate tax advantage in the year the credit is claimed. This change may have a large impact on low-income taxpayers who previously had get the credit over multiple years or even lose some of the credit because of a low tax liability to offset with the nonrefundable credit. In addition, it will also have a large impact for those who finalize adoptions of children with special needs, as the entire credit can be taken regardless of expenses and is no longer dependent on a tax liability to offset. For adoptions of a sibling group with special needs, this may mean very large amounts of refundable credit are immediately available to the adoptive parents.

REVERSION TO PRE-EGTRAA RULES

Even with the changes made by the 2010 legislation which postponed the sunset of the EGTRRA provisions, the pre-EGTRRA rules for adoption tax benefits will return after 2011 unless further legislation is passed. However, the original legislation for these adoption tax benefits also had its own sunset provision effective after 2001, so if the EGTRAA sunset with respect to adoption tax benefits is allowed to take place after 2011, the adoption tax benefits will change drastically. The exclusion will disappear entirely. The adoption tax credit will also disappear except in the case of a child with special needs.

For an adoption of a child with special needs, the \$6,000 credit will still exist but will be limited by the original MAGI phaseout range (\$75,000 - \$115,000). Both the dollar limit and the phaseout range will not be indexed. The credit for adoptions of children with special needs will

only be available for actual qualified adoption expenses. Oftentimes, there are very few actual expenses to adopt a child with special needs, as the costs are covered through other government programs for many of these children who are already in state custody. In addition, the credit would again become nonrefundable with a five-year carryforward period.

There is strong social support for adoption tax benefits. Who could stand up in Congress and speak against them? These benefits seem to have broad, bipartisan support. However, it is still important to recognize the possible results if further legislation is not passed.

POLICY ISSUES

Technically, no tax law is permanent. However, some tax laws are more temporary than others. Some tax laws are specifically passed on a temporary basis for various reasons. One is that the tax benefit may be intended to deal with a temporary situation and thus is legislated for a short time period. Another is that the temporary legislation is a test of a specific benefit to see if it accomplishes its objective. In these cases, the tax law may be extended if it seems to fulfill its purpose. Sometimes tax benefits are passed on a temporary basis because the political capital does not exist to pass them for longer periods of time, perhaps because of the cost involved to the government.

The adoption tax benefits were originally legislated through 2001, likely to see if they accomplished their purpose. These tax benefits were then expanded and extended through 2010. Because of the social desirability of these tax benefits, they have now been extended through 2011. It is likely they will be extended again, but nobody knows when. Also, no one knows what changes will be made to the tax benefits even if they are extended. With this piecemeal legislation, it is difficult to make any long-term plans for using adoption tax benefits, especially since the timing of adoptions is often beyond the control of the adoptive parents for multiple reasons. Currently enacted legislation, if not amended, will result in the reversion at the end of 2011 as mentioned above. This makes it difficult to plan for adoption tax benefits because of their temporary nature and the uncertainty in future legislation. Much of our federal income tax legislation is intended to influence behavior, but it is difficult to have a consistent influence on behavior if the tax benefits are uncertain and subject to change.

It is also true that when tax law changes, the transition from one law to the updated law is not always straightforward, thus leaving it open for misinterpretation or misapplication. When dollar limits and MAGI limits are indexed and change each year, how are amounts treated from one year to the next, especially for a credit or exclusion that may be claimed over several years for any specific adoption effort? As administered by the IRS, during the period from 2002 to 2011 when the dollar limit and the MAGI limit have changed for indexing, the amounts for qualified adoption expenses are subject to the dollar and MAGI limits in the year they become eligible for the credit or exclusion. Thus, if taxpayers had qualified adoption expenses which were eligible for the credit in 2007 equal to or greater than the 2007 dollar limit, they could potentially claim that entire dollar limit for 2007. If they incurred additional qualified adoption expense for that adoption in 2008, they could potentially claim the credit in 2008 for the amount of the increase in the dollar limit as indexed for 2008. However, this line of thinking was not consistently applied when the dollar limit was changed from \$5,000 in 2001 to \$10,000 in 2002. As administered

then, any pre-2002 adoption expenses were limited to the pre-2002 dollar limits, even if these expenses became eligible for the credit in 2002 or later.

For years from 2002 to 2009 any credit that was eligible for carryforward was not again subject to the MAGI limits in the year it actually provided a tax benefit. However, it was subject to the tax liability limit in future years, as it was nonrefundable and thus could only be used to offset existing tax liability. With the change of the credit in 2010 to a refundable credit, the issue then arises as to whether credit amounts carried forward from years prior to 2010 become refundable since the credit is now refundable for 2010 and 2011. The legislation passed in 2010 does not specifically deal with this issue, but the IRS interpretation and implementation is that all adoption credit amounts carried forward from prior years become refundable in 2010 (IRS, 2010a). This interpretation will be of great benefit to any taxpayers who have large amounts of credit carried forward from prior years, some of which may have expired if not used within the five-year carryforward period.

Since the adoption tax credit has increased in amount substantially since its inception in 1997 and because the credit can be claimed for adoptions of children with special needs regardless of the incurrence of adoption expenses, it is not surprising that the IRS has issued guidance that now requires the substantiation of the adoption or adoption effort (IRS, 2010a). This published guidance relates specifically to the credit, but one might also assume substantiation would be required for the exclusion as well. In addition, the state's determination of special needs will also need to be documented in the case of the credit for the adoption of a child with special needs. At this point, taxpayers do not need to submit evidence of specific expenditures (although such documentation should be maintained in case of an audit), but this requirement might not be far off. These efforts may be needed to prevent or minimize fraud related to these potentially large tax benefits related to adoptions.

CONCLUSION

The adoption tax credit and exclusion have evolved significantly since they were first enacted in 1996. The eligibility for more adoptive taxpayers to get more benefits under these tax provisions has grown. The Patient Protection and Affordable Care Act of 2010 made the most recent amendments to these tax benefits, at least for 2010 and 2011. The most significant change from this legislation is that the credit is now refundable. It is likely that additional changes and extensions will be made to tax benefits related to such socially desirable actions. However, policy issues should always be considered when changing or extending these types of tax benefits.

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