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The Adoption Tax Credit:  
Progress and Prospects  
for Expansion

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## Introduction

Since the mid-1990s Congress and a number of states have provided targeted tax relief for families that adopt children. The goal of this legislation has been to promote permanent homes for children through recognition of the substantial upfront cost of adopting a child as well as the extra cost to taxpayers of maintaining children in foster care or another residential setting. This tax relief has come in the form of tax credits, which apply against a family's income tax liability, and deductions, which reduce the amount of income subject to tax. Now that Congress has decided to make the federal adoption tax credit permanent, more states should consider the long-term value of this form of child-friendly tax relief.

Today a bare minority of the states allow deductions or credits against state income tax liability for adoption expenses (a number of states, of course, have no income tax). Tax relief tied to the cost of adoption plays an important role in encouraging permanent homes for foster children, including special-needs children, and it reduces public outlays for many of these children while serving the best interest of the child.

This paper summarizes the history of the federal adoption tax credit and details state policies on the tax treatment of adoption expenses, documenting the room that exists for expansion of these incentives to stabilize the family life of some of society's most vulnerable children.<sup>1</sup>

### **Small Business Job Protection Act of 1996: Birth of the Adoption Tax Credit**

This bill, which combined various tax measures with an increase in the federal minimum wage, was introduced in Congress by Rep. Bill Archer (R) of Texas, then-chairman of the House Ways and Means Committee. The adoption credit embodied in this bill enjoyed strong bipartisan support as a measure to encourage the placement of children in permanent homes by defraying the substantial costs of families typically associated with adoption fees, legal costs, and medical care for the adopted child and his or her mother. The measure was also projected to reduce the overall cost to government of providing foster care for children left in the care of the state.

The main features of the credit were:

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<sup>1</sup> The authors gratefully acknowledge the assistance of the North American Council on Adoptable Children for its information and advice on several topics covered in this paper. The Council's web site (<http://www.nacac.org/>) is an invaluable source of information on a wide range of topics, including details on each state's assistance programs and tax policies regarding adoption. The authors are solely responsible for the content of this paper and encourage any family seeking adoption to pursue professional advice regarding their specific tax situation under state and federal law.

- The maximum amount of the credit for general adoptions was \$5,000 per child, or the actual allowable expenses incurred, whichever was less.
- The maximum allowable amount for a special-needs child was higher, at \$6,000, and this amount could be claimed irrespective of actual expenses.
- The credit was not refundable; that is, it could be used to reduce the adopting person or family's federal income tax liability to zero, but the leftover amount of the credit, if any, could not be paid out to the taxpayer as a cash refund. The unused portion of the credit could, however, be carried forward and claimed in a subsequent year, for a total of five tax years.
- The credit was phased out for taxpayers whose adjusted gross income was between \$75,000 and \$115,000 in the tax year.
- The credit began in 1997.
- The credit was available for "reasonable and necessary adoption fees, court costs, attorney fees, and other expenses."
- The credit was paid for foreign adoptions only when and if finalized; domestic adoption expenses were eligible for the credit whether finalized or not.
- The credit was not available with respect to expenses for an adoption by a spouse, i.e., a step-parent adoption.

This bill was signed into law by President Bill Clinton (D) on August 20, 1996.

### **The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)**

This measure has come to be known as one of the "Bush tax cuts" of Washington lore. In addition to some of its better-known features - across-the-board reduction in tax rates, an expanded child tax credit, education savings accounts, and estate and gift tax relief - EGTRRA increased the previous maximum adoption credit to \$10,000 per child and provided for inflation adjustment of the amount of the credit as well as of the phase-out range in which higher-income earners could claim the credit. As a result of EGTRRA, the adoption credit grew in value for both domestic and international adoptions, though its maximum per-child amount was still well below the average cost of adoption.

- By 2009 the maximum amount of the credit, thanks to the inflation adjustment, had grown to \$12,150; this amount or the actual expenses incurred in the course of a non-special-needs adoption, whichever was less, could be claimed.
- The maximum amount for a special-needs child was also \$12,150 in 2009, and this amount could be claimed irrespective of the actual expenses incurred.
- The credit was not refundable; that is, it could be used to reduce the adopting person or family's federal income tax liability to zero, but the leftover amount of the credit, if any, could not be paid out to the taxpayer as a cash refund. The unused portion of the credit could, however, be carried forward and claimed for a total of five tax years.

- The credit was phased out for taxpayers whose adjusted gross income was between \$150,000 and \$190,000 in 2002. This amount was adjusted for inflation each year and by 2009 the phase-out range over which the value of the credit went from maximum to zero was \$182,180 to \$222,180.
- The increase in the maximum allowable credit came into effect in 2002.
- The credit was available for “reasonable and necessary adoption fees, court costs, attorney fees, and other expenses” reasonably related to the conclusion of the adoption.
- The credit was paid for foreign adoptions only when and if finalized; domestic adoption expenses were eligible for the credit whether finalized or not.
- The credit was not available with respect to expenses for an adoption by a spouse, i.e., a step-parent adoption.
- The credit for non-special-needs adoption was unsettled by the law on December 31, 2010; the credit for special-needs adoptions was continued as permanent.

This bill was signed into law by President George W. Bush (R) on June 7, 2001.

### **The Patient Protection and Affordable Care Act**

Section 10909 of this legislation<sup>2</sup> extended the adoption tax credit into 2011 and set the maximum credit amount by statute at \$13,170 for both regular and special needs adoptions in 2010. The credit itself would continue to be adjusted annually for changes in inflation, as would the income range at which the credit would be phased out for higher earners. The other major change made by this law was to make the credit refundable to taxpayers who exhausted their income tax liability and would otherwise have been eligible only for a limited credit or would have to carry-over the credit to future tax years. Finally, the provision of EGTRRA unsetting the adoption credit was extended from December 31, 2010 to December 31, 2011, breathing another year of life into the credit.

As a result of the continuation of the inflation adjustment under this law, the adoption tax credit grew to its largest size ever, \$13,360 in 2011. In addition, using the inflation adjustment, the credit was phased out for taxpayers whose adjusted gross income was between \$182,520 and \$222,520 for 2010. The credit phase-out for 2011 was between \$185,210 and \$225,210.

This bill was signed into law by President Barack Obama (D) on March 23, 2010.

### **The Tax Relief Act of 2010**

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<sup>2</sup> See H.R. 3590, the Patient Protection and Affordable Care Act, at <http://thomas.loc.gov/cgi-bin/query/F?c111:1:./temp/~c111w76Xwh:e3023791:>

This legislation was adopted in the lame-duck session after the 2010 Congressional elections. In addition to the adoption tax credit, it dealt with an extension of unemployment compensation as well as the perpetuation of the Bush tax credits as both President Obama and Republican Congressional leaders put priority on not raising taxes during the recession. The bill therefore affected capital gains taxes, estate taxes, the child tax credit, marriage penalty relief, and even an extension of a temporary cut in the employee portion of Social Security taxes, meant as a consumer stimulus measure benefiting the “middle class.”

The Act<sup>3</sup> made several changes to the adoption tax credit without affecting the underlying prospect of its return to pre-2001 levels at the expiration date of this tax extension bill.

- The adoption credit was made available for an additional tax year, 2012, under the same general terms as previously with one exception (see below).
- The credit amount for 2012 was calculated using the formula established under EGTRRA and not the amount established as the new base by the Patient Protection and Affordable Care Act, with the result being a maximum credit of \$12,650 (or actual expenses, whichever is less, in the case of a non-special-need adoption) in 2012. The phase-out range for the credit was also calculated this way, resulting in the credit being steadily reduced for joint filers whose adjusted gross income was being \$189,710 and \$229,710 in 2012.
- The refundability of the credit for 2012 and future years was repealed.
- As before, the credit was available for “reasonable and necessary adoption fees, court costs, attorney fees, and other expenses.”
- The credit was also, as before, paid for foreign adoptions only when and if finalized; domestic adoption expenses were eligible for the credit whether finalized or not.
- The credit was not available with respect to expenses for an adoption by a spouse, i.e., a step-parent adoption.

The Tax Relief Act of 2010, whose full name was the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, was signed into law by President Obama on December 17, 2010.

### **The Adoption Credit Cliff**

With the two-year extension of the “Bush tax cuts” about to expire on December 31, 2012, the adoption tax credit, like the Child Tax Credit that was expanded in 2001, would have reverted to its level prior to that law. In other words, absent further action, the adoption credit would once again have maxed out at \$5,000 of actual expenses for most adoptions and a flat \$6,000, irrespective of actual expenses, for children with special needs. Other

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<sup>3</sup> See <http://www.gpo.gov/fdsys/pkg/BILLS-111hr4853enr/pdf/BILLS-111hr4853enr.pdf>.

questions faced policymakers going forward, including whether the credit should be refundable (it had been so for only two of the 15 years the credit had existed) and whether it should be available to higher-income taxpayers. The credit is among a variety of tax-preferences that phase out at upper-income levels, but the phase-out range, relative to other valuable credits for child care, children generally, and education expenses, has been among the most favorable to upper-income Americans in the entire tax code.

By way of comparison:

<b>Federal Credit/Deduction</b>	<b>Phase-Out Range (joint return, year)</b>
Child and dependent care credit	\$15,000 - \$43,000 (2011)
Lifetime learning tax credit	\$104,000 - \$124,000 (2012)
Interest on student loans	\$125,000 - \$155,000 (2012)
Child tax credit	\$110,000 - \$130,000 (2011)
American Opportunity Credit	\$162,000 - \$182,000 (2011)
Adoption tax credit	\$189,710 - \$229,710 (2012)

### **Extending the Adoption Tax Credit**

On September 12, 2012 Sen. Mary Landrieu (D-La.) and six other senators introduced S. 3616, the Making Adoption Affordable Act of 2012, whose major feature was that the credit would no longer have been subject to the sunset provisions of the 2001 law and its extenders. This proposal would have statutorily re-established the maximum allowable adoption credit at the 2010 level of \$13,170 for tax year 2012 and maintained the credit in future years with an inflation adjustment for both the value of the credit and the phase-out ranges for taxpayers. The proposal would also have made the credit refundable again, as it was in 2010 and 2011, maximizing its utility to lower-income taxpayers who adopt children. Other provisions governing the credit would have been unaffected by the legislation.

As noted above, if the fiscal cliff legislation signed on January 2, 2013 had not addressed the extension of the adoption credit, it would have reverted to a maximum of \$5,000 of documented expenses for general adoptions and lost more than half of its 2012 value for special-needs adoptions. Presumably, the phase-out range for the credit would also have declined by more than half, to the 1997 level of \$75,000 to \$115,000. The adoption credit continues to encourage placement of children in families who would otherwise face daunting expenses in finalizing adoptions that can easily cost \$25,000 or more. The credit, moreover, does not erase most typical expenses with adoption and therefore does not subsidize families who are not already willing to make financial and other sacrifices to give a child a permanent home. The benefits to the child, and to taxpayers who may otherwise bear continuing costs for care of these children at public expense, remain enormous.

Fortunately, the final fiscal cliff legislation, H.R. 8, made significant steps forward with respect to the adoption credit and it now offers adoptive families a degree of certainty about both the availability and amount of the credit against their federal income taxes. Most importantly, the legislation makes the credit permanent regarding both general adoptions and adoption of special needs children. While some details of the credit have not been finalized and published due to the mechanics that attended swift passage of H.R. 8, the following features are welcome news for current and potential adoptive families:

- The adoption credit is no longer subject to a sunset provision of federal law.
- The amount of the credit for general adoptions has not been finalized but various sources report that it may be as much as \$12,000 or more for 2013.
- The amount of the credit and the phase-out range will continue to be indexed for inflation, maintaining the value of the credit and the relatively broad income range that can benefit from all or part of this pro-family provision.
- The credit sends a positive message in a climate of new international tension over adoption, due to the passage of a ban on U.S. adoption of Russian children signed into law by President Vladimir Putin on December 28, 2012, just before the credit was saved from expiration. It signals that the United States remains committed to promoting this alternative to institutionalization or abortion of unwanted/unexpected children.

### **State Income Taxes and the Adoption Tax Credit**

A number of states that impose income taxes of their own have augmented the federal tax credit for adoption with credits or deductions of their own. Most of the state policies are not explicitly tied to the existence or the amount of the federal credit and were therefore not affected by potential changes to the federal credit as 2013 began. With the federal credit now made permanent, the Arkansas tax credit, which is set at 20 percent of the allowable amount of the federal credit, will adjust with regular changes in the Internal Revenue Code. Other deduction and credit amounts at the state level are typically set by state statute.

Of the 50 states, eight (Alaska, Florida, Nevada, South Dakota, Tennessee, Texas, Washington and Wyoming) do not have state income taxes of any kind, and a few more are considering proposals to modify or eliminate this type of tax. Of the remaining 42 states plus the District of Columbia, 17 provide some form of credit against taxes or deduction from income to encourage adoption. The other 26 provide no adoption-specific relief at all in order to reduce state income tax reliability. Thus, the majority of U.S. states do not provide any tax-based assistance with adoption (this does not mean an absence of state support for adoption as nearly all states provide some level of adoption assistance, typically in the form of payments to adoptive families to assist with recurring expenses related to an adopted child).

Of the states with adoption support rooted in the tax code (See Table 1), more than two thirds (12 states) offer tax credits, which are subtracted from the final annual income tax a family would incur for the adoption. The five remaining states offer a fixed dollar amount by which the taxpayer can reduce taxable income, thus reducing the tax liability by whatever marginal percentage rate the family would otherwise owe. Because a credit is counted against the final tax owed and is not taken from the amount of taxable income, the credit provides the same benefit to taxpayers of all incomes, provided they have tax liability against which to use the credit. A higher percentage of the reduced tax revenue in these instances will go to assisting families with lower annual income, a feature that can widen the range of families that may be able to afford adoption.

Finally, most states permit the credit or deduction to be taken for the adoption of any child, whether or not the child is special needs or in the state foster care system. International adoptions are generally treated the same way in terms of eligibility for the tax benefit. Kansas, for example, makes its state tax benefit, a \$1,500 credit against eligible expenses, available for taxpayers who adopt either a special needs child or a child in the custody of the state department of social and rehabilitation services. California and Georgia make their tax benefit available only for adoption of children in the care of state agencies. These latter adoptions have a more immediate effect on reducing public expenditures, providing a direct fiscal rationale for the tax policy, but every adoption carries within it both a beneficence dimension (providing a permanent and stable home for a child in a distressed situation) and a fiscal dimension of public expense averted due to the social costs associated with raising children under less than ideal conditions.<sup>4</sup>

Creating a new tax credit or deduction in the states that have both an income tax and no adoption-oriented tax relief (an absolute majority) would be a welcome addition to efforts to support adoption in a period of high out-of-wedlock childbearing in the United States and around the world, which is a strong contributor<sup>5</sup> to the persistence of poverty and a diminution of opportunity for children raised without the benefit of intact families. While

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<sup>4</sup> Robert Rector, "Marriage: America's Greatest Weapon Against Child Poverty," Special Report, No. 117, The Heritage Foundation, Washington, D.C. (September 5, 2012), at [http://thf\\_media.s3.amazonaws.com/2012/pdf/sr117.pdf](http://thf_media.s3.amazonaws.com/2012/pdf/sr117.pdf) (January 17, 2013).

<sup>5</sup> The rate of poverty in single-parent households is dramatically higher than in two-parent households, and this effect persists despite other factors, including parental education. Robert Rector at The Heritage Foundation has documented a more than 80 percent decrease in child poverty based on the marital status of the child's parents. See "Marriage: America's Greatest Weapon Against Child Poverty," Backgrounder #2465, September 16, 2010 at <http://www.heritage.org/research/reports/2010/09/marriage-america-s-greatest-weapon-against-child-poverty> (February 25, 2013). While marital status does not correlate directly with adoption (73,000 never-married men and 100,000 never-married women adopted children in 2002), expressed in terms of percentages married men are 10 times more likely to adopt a child than never-married men, and married women are almost three times more likely to do so. See Jo Jones, Ph.D., "Who Adopts? Characteristics of Women and Men Who Have Ever Adopted," NCHS Issue Brief No. 12, National Center for Health Statistics, U.S. Department of Health and Human Services, January 2009; at <http://www.cdc.gov/nchs/data/databriefs/db12.pdf> (February 25, 2013).

single people adopt a significant number of children each year, the vast majority of children are adopted by married couples, magnifying the potential dollar savings to government from this more beneficial family structure.

Moreover, while direct federal assistance to the U.S. foster care system is significant, the bulk of public expenditures for the system originate with state and local government. This matters, because states that do not now provide for an adoption tax credit or deduction could reduce public expenditures substantially by doing more to encourage adoption.<sup>6</sup> The direct cost of caring for these children is reduced, as adoptive families typically assume the cost of private health insurance and other basic needs, including, in some cases, education.

A brief analysis done for this paper found that nearly half (24) of the U.S. states project budget surpluses for the coming fiscal year. Of these, seven states have no income tax, to which this analysis would not apply. Of the remaining 17 states, ten have tax credits or deductions that could clearly be expanded without fiscal harm and another seven – Indiana, Iowa, Michigan, Minnesota, Nebraska, Oregon and Rhode Island – offer no state income tax relief for adoption at all.

## Recommendations

Making the federal adoption tax credit permanent is a positive step toward ensuring a climate favorable to adoption and slowing down the often costly merry-go-round of foster care. States can continue to foster this climate by:

- Adopting state income tax relief, preferably in the form of credits of equal value across income ranges, in states where no relief is currently granted.
- Increasing the value of the relief in states where the cost of adoption must now be recouped over multiple tax years so that the relief comes closer to reflecting the actual cost of adoption in the year or years it is incurred.

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<sup>6</sup> These reduced costs are significant but, as Nicholas Zill has pointed out, adoption is not a panacea, particularly for children subjected to maltreatment who are adopted out of foster care but still rely on various forms of public support. See Nicholas Zill, "Adoption from Foster Care: Aiding Children while Saving Public Money," Center for Children and Families Brief #43, May 2011, The Brookings Institution, Washington, D.C.; at [http://www.brookings.edu/~media/research/files/reports/2011/5/adoption%20foster%20care%20zill/05\\_adoption\\_foster\\_care\\_zill](http://www.brookings.edu/~media/research/files/reports/2011/5/adoption%20foster%20care%20zill/05_adoption_foster_care_zill) (February 25, 2013). Zill concludes, "[T]he 2007 National Survey of Children's Health and the National Survey of Adoptive Parents provide important insights that can inform and clarify policy debates about how to improve the lives of children who have suffered neglect or abuse and family disruption. The surveys show that adoption can make more extensive family resources and supportive care available to children who have been maltreated and removed from their birth parents. Adoption can provide these benefits at lower cost to the public than foster care or family reunification. At the same time, the findings demonstrate that adoption is not a panacea; improved life circumstances do not readily and rapidly translate into better developmental outcomes for maltreated youngsters."

- Making any tax credit refundable, so that more lower-income families are able to take advantage of this relief. The problem of “wealth transfer” via full refundability can be mitigated by allowing the federal tax credit to be refunded only up to the combined amount of the taxpayers’ income tax liability and the employee portion of FICA.
- Expanding the availability of state adoption tax relief by including non-special needs children in states that currently limited the relief to instances of special need, and increasing the amount of state income tax relief available to families that do adopt children with special needs and therefore face additional costs of care.

PDF Attachment: [Table of State Adoption Tax Relief Policies](#)