

2010

The Effectiveness of the Internal Revenue Code's Adoption Tax Credit: Fostering the Nation's Future?

Leah Carson Kanoy

Follow this and additional works at: <https://scholarship.law.ufl.edu/jlpp>

Recommended Citation

Kanoy, Leah Carson (2010) "The Effectiveness of the Internal Revenue Code's Adoption Tax Credit: Fostering the Nation's Future?," *University of Florida Journal of Law & Public Policy*. Vol. 21: Iss. 2, Article 1.

Available at: <https://scholarship.law.ufl.edu/jlpp/vol21/iss2/1>

This Article is brought to you for free and open access by UF Law Scholarship Repository. It has been accepted for inclusion in University of Florida Journal of Law & Public Policy by an authorized editor of UF Law Scholarship Repository. For more information, please contact kaleita@law.ufl.edu.

NOTES

THE EFFECTIVENESS OF THE INTERNAL REVENUE CODE'S ADOPTION TAX CREDIT: FOSTERING THE NATION'S FUTURE?

*Leah Carson Kanoy**

I.	INTRODUCTION	202
II.	OPERATION OF THE ADOPTION TAX CREDIT	205
	A. <i>History of the Credit—The Adoption Promotion and Stability Act of 1996</i>	205
	B. <i>Mechanics of the Tax Benefits Established by the Economic Growth and Tax Relief Reconciliation Act</i>	206
	1. Current Structure of I.R.C. § 23	206
	2. Amendments to Increase Accessibility to the Credit	207
	3. Amount of Credit Claimed by Taxpayers and Resultant Foregone Revenue	208
	4. Comparison with Federal Spending for Foster Care.....	209
	C. <i>Sunset of EGTRRA Provisions</i>	209
III.	EFFECTIVENESS OF THE CREDIT AT PROMOTING THE ADOPTION OF CHILDREN FROM FOSTER CARE	210
	A. <i>Distributional Issues</i>	210
	B. <i>Potential Sources of the Disparities in Distribution</i>	212
	1. Awareness of the Availability of the Credit	212
	2. Effect of Income on Credit Availability	213
IV.	TAX POLICY ALTERNATIVES.....	213
	A. <i>Tax Expenditure Analysis</i>	213
	1. Defining “Tax Expenditures” and “Tax Incentives”	214
	2. Challenges to the Tax Incentive Analysis.....	215
	B. <i>Use of Tax Expenditures as Substitutes for Direct Government Spending</i>	216

* Leah Carson Kanoy is a student in the Graduate Tax Program at the University of Florida Levin College of law, where she received her J.D. in 2010. Special thanks to Jane Kerhoulas, Edmond Kanoy, Laura Parra, Joshua and Moriah Smith, Jocelyn Steinberg, Laura Kuipers, and Victoria A. Redd for their thoughtful guidance.

1. Upside-Down Effect—Inequitable Effects of Tax Incentives	216
2. Tax Incentives—Encouragement of Private Decision-Making.....	217
3. Windfall Effect of Tax Incentives.....	219
4. Superior Expertise of Direct Expenditure Organizations.....	219
5. Comparative Simplicity of Tax Incentives	221
C. <i>Policy Alternatives—Refundable Tax Credit</i>	221
D. <i>Elimination of the Credit for Adoptions Other than Special Needs Adoptions</i>	223
V. CONCLUSION.....	225
VI. ADDENDUM.....	225

I. INTRODUCTION

In the United States, an estimated 463,000 children are currently in foster care.¹ Of these children, 123,000 (almost 30%) are eligible for adoption.² The majority of these children are classified as having special needs, meaning they are more difficult to place for adoption because of their age; race; membership in a sibling group awaiting adoption; or present physical, mental, or emotional handicap.³ Sadly, while other healthy babies and young children have prospective parents waiting in line to take them home, these special needs children may wait for an adoptive family for years.⁴ Many will never find one.⁵

1. U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES (HHS), TRENDS IN FOSTER CARE AND ADOPTION (2009) [hereinafter TRENDS IN FOSTER CARE AND ADOPTION], available at http://www.acf.hhs.gov/programs/cb/stats_research/afcars/trends.htm. HHS distributes information collected by the Adoption and Foster Care Reporting and Analysis System (AFCARS); this reporting system uses the definition of “foster care” found in the Code of Federal Regulations, where it is defined as “[t]wenty-four-hour substitute care for children placed away from their parents or guardians and for whom the State agency has placement and care responsibility.” *Id.*; 45 C.F.R. § 1355.20 (2009).

2. TRENDS IN FOSTER CARE AND ADOPTION, *supra* note 1. “Children waiting to be adopted include children with a goal of adoption and whose parental rights have been terminated.” *Id.* Note, however, that for data collection purposes, “[c]hildren whose parents’ rights have been terminated, who are [sixteen] years old and older, and who have a goal of emancipation” are excluded from the “waiting” population. *Id.*

3. H.R. REP. NO. 107-064, at 13 (2001), available at <http://thomas.loc.gov/cgi-bin/cpquery/T?&report=hr064&dbname=107&> (last visited Jan. 11, 2011).

4. *Id.*

5. *Id.*

Each year, less than half of these children are adopted⁶ and more than 25,000 children “age out” of foster care (turn eighteen while still in the protective custody of the state) without achieving permanent placement.⁷ This lack of permanency can have enormous detrimental effects on foster children, their communities, and the American public. Early life experiences help determine the way a child thinks, learns, and behaves for the rest of the child’s life.⁸ Children who live through sustained periods in foster care are at an increased risk for mental health problems that may endure throughout their lives. Further, subjecting children to multiple placements destroys continuities that are important to their development. A child without a permanent home may suffer from psychological problems,⁹ including lack of self-worth; failure to form future relationships; and an inability to accept responsibility for self, family, and community well-being.¹⁰

These psychological effects may explain the increased rate of juvenile delinquency in foster children compared to such a rate in non-foster children.¹¹ Foster children have a greater number of delinquency adjudications as minors and an increased rate of adult convictions.¹² In addition, because children who age out of the foster system lack a permanent home, they may have inadequate financial or emotional safety nets as they enter adulthood, leading to high unemployment rates or employment in low-wage positions.¹³

6. TRENDS IN FOSTER CARE AND ADOPTION, *supra* note 1.

7. U.S. DEP’T OF HEALTH & HUMAN SERVS., COMING OF AGE: EMPLOYMENT OUTCOMES FOR YOUTH WHO AGE OUT OF FOSTER CARE THROUGH THEIR MIDDLE TWENTIES 7 (2008), available at <http://aspe.hhs.gov/hsp/08/fosteremp/index.html>.

8. Marsha Garrison, *Reforming Child Protection: A Public Health Perspective*, 12 VA. J. SOC. POL’Y & L. 590, 603 (2005).

9. *See id.* at 611 n.70.

10. *Id.*

11. NAT’L SURVEY OF CHILD & ADOLESCENT WELLBEING (NSCAW), NO. 1: WHO ARE THE CHILDREN IN FOSTER CARE?, http://www.acf.hhs.gov/programs/opre/abuse_neglect/nscaw/reports/children_fostercare/children_fostercare.pdf (last visited Sept. 5, 2010). *See* Joseph J. Doyle, Jr., *Child Protection and Child Outcomes: Measuring the Effects of Foster Care*, 97 AM. ECON. REV. 1583, 1607 (2007), available at http://www.mit.edu/~jjdoyle/fostercare_aer.pdf; Joseph J. Doyle, Jr., *Child Protection and Adult Crime: Using Investigator Assignment to Estimate Casual Effects of Foster Care*, 116 J. POL. ECON. 746, 747 (2008) [hereinafter Doyle, *Child Protection and Adult Crime*], available at http://www.mit.edu/~jjdoyle/doyle_jpe_aug08.pdf. Nearly 20% of the U.S. prison population under the age of 30, and 25% of these prisoners with prior convictions, report spending part of their childhood in foster care; studies have also found higher rates of juvenile delinquency among foster children. Doyle, *Child Protection & Adult Crime*, *supra*, at 747 n.3. Further, foster children are at high risks of other negative life outcomes, including low educational attainment, substance abuse problems, and homelessness. For example, an estimated 28% of the U.S. homeless population spent time in foster care as children. *Id.*

12. *See* Doyle, *Child Protection and Adult Crime*, *supra* note 11, at 747.

13. *See* Garrison, *supra* note 8, at 603 n.45. Garrison states the following:

In recognition of the detrimental effects that prolonged periods in foster care may have on foster children and society, the federal government began offering monetary incentives to increase the number of children adopted from foster care by amending Internal Revenue Code (I.R.C. or Code) § 23, commonly now known as the adoption tax credit (the credit).¹⁴ The credit was nonrefundable, and its purpose was to offset adoption costs, and to lessen financial barriers faced by potential adoptive parents, with an emphasis placed on the adoption of children from foster care.¹⁵ Although the amount of money available under the credit was increased in 2001, this increase is set to expire on December 31, 2010.¹⁶ Because the sunset date is approaching, policymakers will soon decide whether to alter the current provisions or to make them permanent. This Note will examine the effectiveness of the credit, particularly in promoting the adoption of foster children, and it will explore potential alternative taxation policies.

Children who remain in foster care until the age of majority . . . exhibit a wide range of profoundly dysfunctional behaviors. A national study of the Title IV-E foster care independent living program, which is supposed to assist foster children in the transition to self-sufficiency, found that, thirty months to four years after aging out of the system, forty-six percent of those surveyed had not completed high school, thirty-eight percent had not held a job for longer than one year, twenty-five percent had been homeless for at least one night, sixty percent of women had given birth to a child, and forty percent had been on public assistance, incarcerated, or a cost to the community in some other way.

Id. at 603. See Madelyn Freundlich, N. Am. Council on Adoptable Children, *The Value of Adoption Subsidies: Helping Children Find Permanent Families* (2008), available at <http://www.nacac.org/adoptionssubsidy/valueofsubsidies.pdf>.

14. I.R.C. § 23 (2009). This statute was reclassified as refundable as of March 23, 2010, and transferred to Subpart C. See I.R.C. § 36(c). In May 2008, Florida responded to this problem by launching its “Explore Adoption” campaign. As part of the campaign, Florida Governor Charlie Crist made increased adoption awareness and the well-being of all Florida children a priority, and created the Office of Adoption and Child Protection to establish a comprehensive statewide approach for promoting adoption. Fla. Office of Adoption & Child Prot. Annual Report (2008), available at <http://www.flgov.com/pdfs/ChildAdvocacy/oacpannualreport2008.pdf>.

15. Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, § 202, 115 Stat. 38, 47-49 (codified as amended in scattered sections of 26 U.S.C. (2001)).

16. *Id.*; see *infra* notes 171 and 172 for the amended sunset provisions.

II. OPERATION OF THE ADOPTION TAX CREDIT

A. History of the Credit—The Adoption Promotion and Stability Act of 1996

In 1996, Congress introduced the Adoption Promotion and Stability Act (the Act) to help families “defray adoption costs.”¹⁷ A report issued by the Committee on Ways and Means states the reason for the legislation: “[T]he financial costs of the adoption process should not be a barrier to adoptions. In addition, the Committee wishes to further encourage the adoption of special needs children.”¹⁸ The Act was ultimately subsumed into section 1807 of the Small Business Job Protection Act of 1996 (SBJPA).¹⁹

At the time of its passage, SBJPA introduced a nonrefundable tax credit of \$6,000 for adoptive parents of children with special needs, and a nonrefundable tax credit of \$5,000 for the adoptive parents of all other children.²⁰ A child was considered to have special needs if a state determined that (1) the child could not or should not be returned to the parental home, and (2) that a specific factor existed (such as age, ethnic background, or membership in a sibling group) that warranted the state’s assistance in placing the child with adoptive parents.²¹ SBJPA also included an income eligibility phase-out range beginning at an annual adjusted gross income (AGI) of \$75,000, and completely phasing out for an AGI of \$115,000 or more.²²

17. H.R. REP. NO. 104-542, pt. 2, at 38 (1996), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=104_cong_reports&docid=f:hr542p2.104.pdf.

18. *Id.* at 17.

19. Small Business Job Protection Act, Pub. L. No. 104-188, § 1807, 110 Stat. 1755, 1899-1903 (codified as amended at 42 U.S.C. §§ 671, 674, 1996b (1996)).

20. *Id.* § 1807. An eligible child, whether classified as special needs or not, must be under eighteen years old, or be physically or mentally incapable of caring for himself or herself. *Id.* § 1807.

21. *Id.* § 1807. U.S. citizenship or residency was (and continues to be) required for qualification as a special needs child. *Id.* § 1807; I.R.C. § 23(d)(3)(C) (2009). The adoption classification in Florida illustrates state-specific criteria; Florida requires a child to have one of the following conditions for a special needs determination: of age eight or older, developmentally disabled, physically or emotionally handicapped, part of a sibling group being placed together, or black or bi-racial. FLORIDA’S “EXPLORE ADOPTION” CAMPAIGN FREQUENTLY ASKED QUESTIONS, <http://www.adoptflorida.org/about5.shtml> (last visited Sept. 8, 2010).

22. Small Business Job Protection Act § 1807.

B. *Mechanics of the Tax Benefits Established by the Economic Growth and Tax Relief Reconciliation Act*

1. Current Structure of I.R.C. § 23

Citing the success of SBJPA in reducing the costs of adoption, Congress passed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) in 2001 to “encourage more adoptions and allow more families to afford adoption.”²³ In an effort to promote congressional goals, EGTRRA increased the tax credit available under I.R.C. § 23 for all qualified²⁴ adoption-related expenses up to \$10,000, including those related to adoptions of special needs children.²⁵ Beginning in 2002,

23. H.R. REP. NO. 107-064, at 5 (2001).

24. The Code defines qualifying expenses to include reasonable and necessary adoption fees, court costs, attorney fees, traveling expenses (including amounts spent for meals and lodging while away from home), and other expenses directly related to and for which the principal purpose is the legal adoption of an eligible child. I.R.C. § 23(d)(1) (2009). Qualifying expenses exclude expenses connected to the adoption of a step-child and any reimbursed expenses, such as those reimbursed under an employer program. *Id.* § 23(d)(1). For qualifying expenses paid prior to the year the adoption becomes final, the credit generally is allowed for the year following the year of payment, including cases of failed adoptions. *Id.* § 23(a)(2). An exception exists for the adoption of children who are not U.S. citizens or residents; the credit cannot be claimed for expenses relating to foreign adoptions that are not finalized. *Id.* § 23(e). A taxpayer who paid qualifying expenses in the current year for an adoption which became final in the current year may be eligible to claim the credit for the expenses on the current year return, in addition to credit for expenses paid in a prior year. *Id.* § 23(a)(2). Although the adoption credit is not available for any reimbursed expenses, I.R.C. § 23(b)(3)(A) (2009), amounts paid by a taxpayer’s employer for qualifying adoption expenses are excludable from the taxpayer’s gross income. Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, § 202, 115 Stat. 38, 47-49 (codified as amended in scattered sections of 26 U.S.C. (2001)); I.R.C. § 137(a) (2009). Under EGTRRA, the amount of tax-free employer adoption assistance is the amount of qualified adoption expenses up to \$10,000, indexed for inflation and subject to the same phase-out restrictions as I.R.C. § 23. I.R.C. § 137(a),(b),(f) (2009); I.R.C. § 23 (2009). If a taxpayer is eligible to claim the credit and the exclusion, the taxpayer may claim both, and the limitation applies separately to each. I.R.C., TOPIC 607—ADOPTION CREDIT (2009), available at <http://www.irs.gov/taxtopics/tc607.html>.

25. The term child with special needs means any child if-

(A) a State has determined that the child cannot or should not be returned to the home of his parents,

(B) such State has determined that there exists with respect to the child a specific factor or condition (such as his ethnic background, age, or membership in a minority or sibling group, or the presence of factors such as medical conditions or physical, mental, or emotional handicaps) because of which it is reasonable to conclude that such child cannot be placed with adoptive parents without providing adoption assistance, and

(C) such child is a citizen or resident of the United States

I.R.C. § 23 (d)(3) (2009). *See supra* text accompanying note 21.

EGTRRA raised the phase-out range to AGIs of \$150,000-\$190,000.²⁶ Further, under EGTRRA, if a taxpayer lacks the tax liability to claim the full credit, the unused portion of the credit can be carried forward for an additional five years.²⁷

2. Amendments to Increase Accessibility to the Credit

In 2003, the credit became more accessible to families adopting children with special needs.²⁸ Out of concern that EGTRRA would do too “little to promote the adoption of the many special needs children in foster care,”²⁹ the Act mandated that, beginning in 2003, families adopting a special needs child would not need to document “qualified” adoption-related expenses in order to claim the credit.³⁰ Thus, adoptive parents whose income satisfies the phase-out requirements can claim the full credit without documenting that they incurred a specific level of qualified expenses.³¹

This provision was a significant step toward breaking down the barriers to the adoption of foster children.³² In a report to the House of Representatives, the Committee on Ways and Means indicated that while parents who adopt privately or internationally (foreign adoptions) can easily document adoption-related expenses, parents adopting from public agencies face difficulties in documenting “qualified” expenses.³³ Parents who adopt privately, whether through domestic or foreign adoptions, typically incur significant agency fees, travel expenses, and attorneys’ fees, which are easily reported.³⁴ However, costs for home studies and agency fees for parents adopting children from foster care are often waived or reimbursed through the nonrecurring costs

26. I.R.C. § 23(b)(2) (2009). Both the tax credit and income limitations were indexed for inflation. I.R.C. § 23(h) (2009). For taxable years beginning in 2009, the credit allowed is \$12,150. I.R.C. § 23(b)(1), (h) (2009). The 2009 phase-range begins for taxpayers with AGIs in excess of \$182,180, and the credit is completely phased out for taxpayers with AGIs of \$222,180 or more. I.R.C. § 23(b)(2), (h) (2009).

27. I.R.C. § 23(c) (2009).

28. I.R.C. § 23(a)(3) (2009).

29. H.R. REP. NO. 107-064, at 13 (2001).

30. I.R.C. § 23(a)(3) (2009).

31. *Id.*

32. See H.R. REP. NO. 107-064, at 13 (2001). See also ROB GREEN, CHILD TRENDS, THE ADOPTION TAX CREDIT: IS IT AN EFFECTIVE APPROACH TO PROMOTE FOSTER CARE ADOPTION? 1, 5 (2007), available at http://www.childtrends.org/Files/Child_Trends-2007_08_07_RB_AdoptionTaxCredit.pdf (stating that the number of adoptions from foster care supported by the credit more than doubled between 2002 and 2003 after Congress removed the requirement of documenting expenses).

33. See H.R. REP. NO. 107-064, at 13 (2001).

34. See *id.*

provisions of states' adoption assistance programs.³⁵ The latter adoption-related costs are more likely to include housing modifications, and ongoing medical and counseling services, none of which are qualified adoption-related expenses as defined by the Code provision.³⁶

3. Amount of Credit Claimed by Taxpayers and Resultant Foregone Revenue

In its Report to Congress on Tax Benefits for Adoption, the Department of the Treasury stated that, in tax year 1998, adoptive parents of only 15% of eligible special needs children applied for the credit.³⁷ Of the few families adopting special needs children who benefited from the credit, 71% reported expenses under the current \$6,000 limit for eligible expenses incurred in connection with a special needs adoption.³⁸ Further, in 1998, special needs adoptions accounted for only 8% of the total credit taken, and such families generated about \$3,500 in qualified adoption expenses per adoption.³⁹ Thus, simply raising the limit on eligible expenses to \$10,000 would have done little to help parents adopt special needs children. Moreover, some members of Congress viewed the elimination of the documentation requirement as a necessary step toward reaching the goal of obtaining permanency for foster children.⁴⁰

In its 2001 Report to the House, the Congressional Budget Office and the Joint Committee on Taxation estimated that the EGTRRA provisions allowing the adoption credit and exclusion for employer-reimbursed expenses would cause the following government revenue losses:⁴¹ \$47 million in fiscal year 2002, by \$973 million over the 2002-2006 period, and by approximately \$2.6 billion over the 2002-2011 period.⁴² For 2009-2010, specifically, the Joint Committee on Taxation estimates \$800 million in lost revenue.⁴³

35. *See id.* at 4, 13.

36. *See id.* at 13; I.R.C. § 23(a)(3) (2009).

37. U.S. TREASURY REP., TAX BENEFITS FOR ADOPTION 2 (2000), available at <http://www.treas.gov/offices/tax-policy/library/adoption.pdf>.

38. *Id.*

39. *Id.*

40. *See* H.R. REP. NO. 107-064, at 13 (2001).

41. *Id.* at 7.

42. *Id.*

43. STAFF OF J. COMM. ON TAXATION, ESTIMATES OF FED. TAX EXPENDITURES FOR FISCAL YEARS 2008-2012, at 55 (2008), available at <http://www.jct.gov/s-2-08.pdf>.

4. Comparison with Federal Spending for Foster Care

While the tax credit has resulted in over \$1 billion in lost revenue, this amount is far less than what federal government spends on foster care. According to the Department of Health and Human Services, foster care funding represents 65% of the federal funds dedicated to child welfare programs.⁴⁴ Federal spending for foster care for fiscal year 2008 was approximately \$4.5 billion, with similar estimates for 2009 and 2010.⁴⁵ Because an increase in the number of children adopted from foster care has the potential to decrease the amount of foster care funding, the credit may help offset the cost of foster care, making it well worth the expense.⁴⁶

C. Sunset of EGTRRA Provisions

Unless further legislation is enacted, the EGTRRA provision that increased the amount of money that adoptive families may claim, as well as the provision that increased the income eligibility phase-out range, will sunset on December 31, 2010.⁴⁷ Thus, beginning in 2011, the adoption credit allowance will decrease to the SBJPA (pre-EGTRRA) level⁴⁸ of \$6,000 per special needs child and \$5,000 per non-special needs child.⁴⁹ Additionally, adoptive families reporting \$75,000-\$115,000 in AGI will again be restricted in the amount they may claim, and those reporting more than \$115,000 will be prohibited from claiming any credit amount.⁵⁰

Congress has introduced several bills that would repeal the sunset and make the EGTRRA reforms of the adoption tax credit permanent. Most recently, legislators proposed the Adoption Tax Relief Guarantee Act of 2009, which would make the credit permanent.⁵¹ On January 6,

44. U.S. DEP'T OF HEALTH & HUMAN SERVS., FEDERAL FOSTER CARE FINANCING: HOW AND WHY THE CURRENT FUNDING STRUCTURE FAILS TO MEET THE NEEDS OF THE CHILD WELFARE FIELD 2 (2005), available at <http://aspe.hhs.gov/hsp/05/fc-financing-ib/ib.pdf>.

45. CHILD WELFARE LEAGUE OF AMERICA, FUNDING FOR SELECTED CHILDREN'S PROGRAMS 1 tbl.1 (2009), available at <http://www.cwla.org/advocacy/budgetdetails09.htm>.

46. See H.R. REP. NO. 107-064, at 14 (2001).

47. Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16 § 901, 115 Stat. 38, 150 (codified as amended in scattered sections of 26 U.S.C. (2001)).

48. *Id.* § 901.

49. Small Business Job Protection Act, Pub. L. No. 104-188, 110 Stat. 1755, 1899 (codified as amended at 42 U.S.C. §§ 671, 674, 1996b (1996)).

50. *Id.* § 1807.

51. Adoption Tax Relief Guarantee Act of 2009, H.R. 213, 111th Cong. § 2 (2009), available at <http://www.govtrack.us/congress/bill.xpd?bill=h111-213> (exempting provisions expanding the adoption tax credit and adoption assistance programs enacted by EGTRRA from the general terminating provisions).

2009, the bill was referred to the House Committee on Ways and Means, where it has remained without enactment.⁵²

III. EFFECTIVENESS OF THE CREDIT AT PROMOTING THE ADOPTION OF CHILDREN FROM FOSTER CARE

A. *Distributional Issues*

With the sunset date on the horizon, recent debate has focused on the effectiveness of the credit at promoting adoptions of foster children. Unfortunately, no data is currently available that specifically evaluates the credit's effect on one's ability or decision to adopt.⁵³ However, preliminary research shows a significant and positive correlation between a state's level of financial assistance for adoptive parents and its rate of adoptions from foster care.⁵⁴ In particular, studies suggest that increased subsidies to adoptive parents increased the number of adoptions.⁵⁵ If direct, state subsidies to parents in the form of monthly adoption assistance payments increase the adoption rate for children in foster care, then by analogy, the federal subsidy provided by the credit should also have a positive effect.⁵⁶

Although research for the credit's effect on the decision to adopt is lacking, statistics for distribution of the credit are available.⁵⁷ Encouraging data suggest that adoptive parents are taking greater advantage of the credit, whether they adopt children through private or foreign adoptions, or from foster care.⁵⁸ There has been a substantial

52. H.R. 213. In January 2005, a similar bill was introduced to make permanent the expansion of the credit as introduced in EGTRRA. Adoption Tax Relief Guarantee Act of 2005, S. 246, 109th Cong. § 2 (2005), available at <http://www.govtrack.us/congress/bill.xpd?bill=s109-246>. The bill had strong support in the House, gaining seventy-four representative co-sponsors, but it later failed in the Senate. *Id.* Thus, much speculation exists concerning the fate of the current bill.

53. See Freundlich, *supra* note 13.

54. *Id.* at 3.

55. See *id.* But see Gopi Shah Goda & Kevin J. Mumford, *Fertility Response to the Tax Treatment of Children* 28 (Purdue Univ. Krannert Working Paper Series, Paper No. 1219, 2009), available at <http://www.krannert.purdue.edu/programs/phd/Working-paper-series/Year-2009/1219.pdf> (studying the effect of the child tax credit on fertility rates and finding that overall estimates of the fertility response to child tax benefits are statistically insignificant; however, authors note concerns related to the analysis utilized and urge caution in applying their results).

56. See Freundlich, *supra* note 13, at 5.

57. U.S. TREASURY REP., FEDERAL INCOME TAX BENEFITS FOR ADOPTION: USE BY TAXPAYERS 1999-2005, at 1, 7 tbl.1 (2007), available at <http://www.fosteringconnections.org/tools/assets/files/AdoptionTaxCreditStudy2007-1.pdf>.

58. *Id.*

increase in the amount of money spent on the adoption tax credit, as well as in the amount of unused credit carried forward.⁵⁹ The total amount of tax benefits received more than tripled between 1999 and 2005, from \$103 million to \$355 million.⁶⁰ Over the same period, the amount of unused credit carried forward increased over 400%, from \$82 million to \$414 million.⁶¹

Although the amount of adoption tax credit dollars received by adoptive parents increased dramatically, more than 82% of the total dollars spent went toward supporting children adopted privately or from foreign countries.⁶² On a national level, the number of children adopted from foster care has remained virtually unchanged since 2000; between 2000 and 2005, the number of foster children adopted increased by only 1%.⁶³ During the same period, foreign adoptions increased by 28%.⁶⁴

Data suggests that the tax credit, as it is currently structured, is not meeting its original goal of promoting adoptions from foster care.⁶⁵ Of primary concern is the small number of adoptions from foster care supported by the credit compared to private adoptions.⁶⁶ In 2004, private adoptions accounted for almost half of the children supported by the credit and 38% of the dollars spent.⁶⁷ Foreign adoptions accounted for just over a third of the children supported and 45% of the dollars spent.⁶⁸ Foster children accounted for only 18% of the children supported and 17% of dollars spent.⁶⁹ Thus, the vast majority of adoption tax credit recipients completed private or foreign adoptions rather than adoptions from foster care.⁷⁰ Further, almost all foreign adoptions benefited from the tax credit, compared to only approximately 25% of foster care adoptions.⁷¹ These numbers suggest that although Congress furthered its objective of lessening financial barriers for adoptions generally, the credit has not achieved its goal regarding foster children.⁷²

59. *Id.*

60. *Id.*

61. *Id.*

62. GREEN, *supra* note 32, at 4.

63. *Id.* at 3.

64. *Id.*

65. *Id.* at 4-5.

66. *Id.* at 2.

67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.* at 1.

72. *Id.* at 4-5.

Another concern is that the credit disproportionately supports higher-income families.⁷³ In 2005, \$355 million was claimed in allowable adoption tax credits.⁷⁴ Of this amount, approximately two-thirds were received by tax filers with incomes of \$75,000 or greater.⁷⁵ Family income also tends to correlate with the type of adoption.⁷⁶ Foreign adoptions accounted for almost half of adoptions completed by filers with incomes above \$100,000, perhaps because waiting periods may be shorter for foreign adoptions than for private domestic adoptions, and this income group can afford the higher cost associated with some foreign adoptions.⁷⁷ Further, foster care adoptions accounted for only 10% of the adoptions completed by filers with incomes over \$100,000.⁷⁸ Most notably, when comparing types of adoptions by income group, adoptive families with incomes less than \$25,000 adopted a greater percentage of children from foster care relative to private and foreign adoptions than any other income group.⁷⁹

B. Potential Sources of the Disparities in Distribution

1. Awareness of the Availability of the Credit

The North American Council of Adoptive Children (NACAC) partially attributes the low rate of credit claimed by those adopting special needs children to a lack of awareness of the credit.⁸⁰ In 2008, Congress sought to address this concern by enacting the Fostering Connections to Success and Increasing Adoptions Act.⁸¹ This Act added a new requirement that states must inform individuals adopting or considering adopting a child from foster care of their potential eligibility for the credit.⁸²

73. *Id.* at 2.

74. *Id.*

75. *Id.*

76. *See id.* tbl.2.

77. *See id.* at 2-3.

78. *Id.* at 2.

79. *See id.* tbl.2. Adoptions from foster care accounted for 29% of the adoptions by families with incomes under \$25,000, compared with 26% of adoptions by families with incomes of \$25,000-49,999, 20% of the \$50,000-74,999 income group, 16% of the \$75,000-99,999 income group, 11% of the \$100,000-155,860 income group, 8% of the \$155,860-195,860 income group, and only 4% of families with incomes of \$195,860 or greater. *Id.* *See* U.S. TREASURY REP., *supra* note 57, at 8 tbl.1999-1.

80. N. AM. COUNCIL ON ADOPTABLE CHILDREN, *New Federal Law Overhauls U.S. Child Welfare Financing* (2008), available at <http://www.nacac.org/policy/hr6893summary.html>.

81. *See* Fostering Connections to Success and Increasing Adoptions Act of 2008, Pub. L. No. 110-351, § 403, 122 Stat. 3949 (2008) (codified as amended at 42 U.S.C. § 1305 (2008)).

82. N. AM. COUNCIL ON ADOPTABLE CHILDREN, *supra* note 80. Data has not yet been compiled to assess the value of the legislation, which is discouraging given EGTRRA's

2. Effect of Income on Credit Availability

The low income level of many families adopting foster children creates a significant barrier to accessing the credit.⁸³ Families with incomes less than \$25,000 comprise the income group with the greatest percentage of adoptions from foster care compared to private and foreign adoptions.⁸⁴ Generally, these families do not have the requisite tax liability to claim the full value of the credit.⁸⁵ Increasing awareness of the availability of the credit may enable more higher-income families to benefit from it, but raising public awareness will have no effect on families incapable of claiming the credit due to their insufficient tax liability.⁸⁶ Because of this impediment, some adoption advocacy groups have campaigned for the transfer of the credit into a refundable credit, paid fully to families adopting foster children.⁸⁷

IV. TAX POLICY ALTERNATIVES

Because EGTRRA's sunset date is approaching, analysis of the adoption credit is necessary to determine whether the current provisions should be altered or made permanent. The adoption tax credit is clearly not fulfilling its primary goal of promoting adoption from foster care. Thus, this Note will address policy alternatives to the current tax credit. The analysis will focus on the concept of tax expenditures as advanced by Professor Stanley Surrey, and it will also discuss several objections to the tax expenditure analysis. This examination will reveal that transforming the current credit into a refundable credit is a favorable alternative.

A. Tax Expenditure Analysis

An initial query is whether the congressional goal of promoting adoptions, particularly special needs adoptions such as the adoption of foster children, is furthered more effectively by the use of a tax credit, as opposed to other means. Perhaps taxpayer dollars would be better spent on direct government programs that could encourage recruitment

upcoming sunset date. Analysis of the Act's usefulness could aid Congress in determining whether EGTRRA's shortcomings in promoting adoptions from foster care could be rectified by increased awareness, in lieu of revision to the current credit allowance or reversion to its pre-EGTRRA design.

83. GREEN, *supra* note 32, at 5.

84. *Id.* at 2 tbl.2.

85. *Id.* at 5.

86. *Id.*

87. *See id.*

of adoptive parents, offer medical services to adoptive families, or provide cash payments to adoptive families. Professor Surrey laid the foundation for such an inquiry under the theory of tax expenditures.

1. Defining “Tax Expenditures” and “Tax Incentives”

Tax provisions such as the adoption credit under I.R.C. § 23 are identified as “tax expenditures” by the Treasury and by Congress.⁸⁸ These expenditures are categorized as spending provisions of the Code, in the form of foregone revenue, rather than as revenue-raising provisions.⁸⁹ Such expenditures are defined under the Congressional Budget and Impoundment Act as “those revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.”⁹⁰ This definition stems from Professor Surrey’s tax policy analysis. Professor Surrey separated tax provisions into two groups: (1) the “structural” provisions necessary to implement a normal income tax, and (2) the “special preference” provisions favoring a particular activity or class of individuals.⁹¹

Under Surrey’s analysis, provisions are identifiable as tax expenditures because they achieve a specified purpose other than the measurement of net income, and “represent government expenditures made through that system to achieve various social and economic objectives.”⁹² Surrey further separated Code provisions by dividing tax

88. Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155, 1155 (1988). The Treasury published its first tax expenditure analysis in 1968 when Stanley Surrey served as Assistant Secretary of the Treasury for Tax Policy. See STAFF OF J. COMM. ON TAXATION, A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS, at 18 (2008), available at <http://www.jct.gov/x-37-08.pdf>.

89. *Id.*

90. Congressional Budget and Impoundment Act of 1974, Pub. L. No. 93-344, § 3, 88 Stat. 297, 299 (codified as 2 U.S.C. §§ 601-688 (1974)).

91. Eric Zolt, *Deterrence via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343, 346 (1989) (citing STANLEY S. SURREY, *PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES* (1973)). Using Surrey’s approach, structural provisions define net income and specify accounting periods, rate schedules, and exemption levels. *Id.* Special preference provisions include exemptions, exclusions, preferential tax rates, deductions, and credits against tax. *Id.* at 346-47. In Surrey’s effort to differentiate tax expenditures, he began with the Haig-Simons definition of income. The Haig-Simons approach taxes an individual on the sum of (1) the market value of rights exercising consumption and (2) the change in value of property rights between the beginning and end of a time period. *Id.* at 347 n.19. Surrey then adjusted for “generally accepted” concepts of taxation, such as nontaxation of unrealized gains, exclusion of imputed income from owner-occupied homes, and certain standard financial accounting practices.” *Id.* at 347 (citing SURREY, *supra*). All variations from this base line that benefited taxpayers were considered tax expenditures. *Id.*

92. Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy*:

expenditures into two groups, those identified as tax incentives, and those not identified as such.⁹³ He defined "tax incentives" as tax expenditures that induce certain behavior "in response to the monetary benefit available."⁹⁴ In contrast, tax expenditures that are not tax incentives but merely normative provisions, such as those designed to provide tax relief for those with physical handicaps and other personal hardship, are related to the involuntary behavior of taxpayers.⁹⁵ Under this analysis, the credit can be considered a tax incentive, because its purpose is to provide monetary assistance through the Code to make adoption financially "more palatable" to taxpayers, and thus induce them to adopt.⁹⁶

According to Surrey, the social goals of tax incentives are similar in nature to those of direct government expenditures, such as interest subsidies, direct federal loans, and federal grants.⁹⁷ Surrey's approach was presumably a response to the tendency of policymakers to utilize the Code as a replacement for direct government spending.⁹⁸ The term "tax expenditure" may have been chosen to suggest that these tax provisions are equivalent to direct government spending programs, but are utilized through the Code.⁹⁹

Under Surrey's analysis, tax expenditures may be viewed as mere substitutes for direct government assistance programs.¹⁰⁰ For example, tax credits given to adoptive parents may be a substitute for programs designed to offer families post-adoptive care, such as programs that provide free counseling services or programs that direct cash assistance.¹⁰¹

2. Challenges to the Tax Incentive Analysis

Some opponents of the tax incentive analysis argue that Surrey's basic

A Comparison with Direct Government Expenditures, 83 HARV. L. REV. 705, 706 (1970).

93. *See id.* at 711.

94. *Id.*

95. *Id.* at 712.

96. *Id.* at 713.

97. *Id.*

98. Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973, 978 (1986).

99. Mary Louise Fellows, *Rocking the Tax Code: A Case Study of Employment-Related Child-Care Expenditures*, 10 YALE J.L. & FEMINISM 307, 379 (1998) (citing SURREY, *supra* note 91).

100. *See Zelinsky, supra* note 98, at 978.

101. *See id.* As another example, tax credits given to employers for hiring the "chronically unemployed" may be a substitute for a system of direct cash payments from the government to the employers. *Id.* Similarly, tax credits given to adoptive parents may be a substitute for programs designed to offer families post-adoptive care, such as by providing free counseling services, or direct cash assistance programs. *Id.*

premise is unusable.¹⁰² These opponents reason that it is not possible to classify provisions as either “normative” or “incentive” because one taxpayer’s incentive is another’s “normative deduction.”¹⁰³ Professor Edward Zelinsky cites several examples of provisions that could be described as tax incentives but could equally be classified as normative provisions.¹⁰⁴ For example, the childcare costs of a working parent could be treated as nondeductible personal expenses or as deductible business-related expenses.¹⁰⁵ Thus, the premise of tax incentive analysis—“the existence of an ideal, normative tax against which to measure expenditure-type deviations”—is flawed because it disregards “value-laden choices inherent in the design of an income tax.”¹⁰⁶

Regardless of its opposition, Surrey’s concept of tax incentives has become a central instrument in tax analysis.¹⁰⁷ This discussion will utilize his framework for analyzing which approach—use of tax incentives or direct spending—is the better vehicle to promote the adoption of special needs children.

B. Use of Tax Expenditures as Substitutes for Direct Government Spending

1. Upside-Down Effect—Inequitable Effects of Tax Incentives

Inherent in the use of tax incentives, such as the adoption credit, is the notion that “the better off the taxpayer, the greater the financial benefit.”¹⁰⁸ Nonrefundable tax credits typically offer the greatest benefit to taxpayers in the highest marginal tax bracket allowed under the credit, because these individuals have the requisite tax liability to claim the credit, and are also more likely to seek the aid of tax preparers to ensure that all available tax benefits are utilized.¹⁰⁹ Thus, those who may need the assistance the most are less likely to receive it, resulting in distributional unfairness and the “upside-down” effect of tax expenditures.¹¹⁰ Direct spending programs are rarely, if ever, structured in the same manner, and are generally equally accessible by individuals

102. *Id.* at 978.

103. *Id.*

104. *Id.* at 979.

105. *Id.*; see Fellows, *supra* note 99, at 375. Similarly, moving costs for the relocation of an entire family arising from one parent’s job offer in another location could be classified as nondeductible personal expenses or as business expenses. See Zelinsky, *supra* note 98, at 979.

106. See Zelinsky, *supra* note 98, at 979.

107. See *id.* at 978.

108. STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 108 (1985).

109. See *id.*

110. See *id.*

with lower incomes.¹¹¹

Further, because the credit itself is not included in income, the incentive provides both financial assistance and tax relief.¹¹² According to Professor Surrey, this benefit is another form of tax incentive that has the same upside-down effect as the original incentive.¹¹³ This freedom from tax provides a greater benefit to taxpayers in higher brackets than to those with less income and correspondingly less tax liability.¹¹⁴ Thus, the distributional inequity is compounded.¹¹⁵

2. Tax Incentives—Encouragement of Private Decision-Making

The underlying upside-down effect of tax incentives is more tolerable when considered alongside the advantages that incentives may provide over direct government spending. Tax incentives may be preferable because they promote individual decision-making, unlike direct expenditures, which seemingly result from government decision-making.¹¹⁶ Private decision-making, including the use of private initiative and capital, may be aimed toward socially useful projects. Thus, tax incentives may more effectively encourage individuals to solve social problems.¹¹⁷

However, direct expenditure programs can also be designed to allow for flexibility and individual decision-making.¹¹⁸ Surrey cites the charitable contribution deduction as an example.¹¹⁹ Because the taxpayer selects the charity and determines the amount of the gift, the taxpayer has control of her spending.¹²⁰ However, a direct expenditure program could be structured similarly; the taxpayer could choose a charity, decide on an amount to give, and the government could match the donation, thus preserving private decision-making.¹²¹ Similarly, in lieu of the credit, the government could offer free support services to adoptive families, such as counseling and medical services provided by facilities of the families' choice. Or, for maximum flexibility, the credit could be transformed into a direct government grant in the form of a refundable credit.

However, the freedom of choice associated with tax incentives is not

111. *See id.*

112. Surrey, *supra* note 92, at 723.

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.* at 718.

117. *Id.*

118. *Id.*

119. *Id.* at 719.

120. *Id.*

121. *Id.*

equally associated with direct spending programs. Tax incentives are designed to openly encourage private decision-making, which is consistent with American principles of free enterprise and individual choice.¹²² Taxpayers are able to determine their own eligibility, and because individuals do not have to apply for the government funds directly, the eligibility choice given to taxpayers could have a significant psychological effect.¹²³ Due to the negative connotations associated with the receipt of direct assistance, as opposed to the receipt of “tax” benefits, taxpayers may be less likely to seek direct assistance.¹²⁴

According to Surrey, this view is “sheer illusion;” regardless of whether government funds are spent through a direct program or a tax incentive, “the fact remains that the funds come from government.”¹²⁵ However, Surrey acknowledges that the government may use tax incentives to “foster the illusion” that private individuals are making spending decisions.¹²⁶ If, as Surrey suggests, this illusion is effective at masking the government’s true spending role and thus less likely to face attack by taxpayers, perhaps tax incentives provide an actual benefit by increasing the likelihood that the assistance will be offered and utilized.

Those who oppose this concept point to the danger inherent when government actions lack visibility. Unlike direct spending programs, which are quick to attract attention, tax expenditures are “largely invisible.”¹²⁷ Thus, policymakers who “do not want to appear to be big spenders can comfortably approve tax expenditures without damaging their images of fiscal conservatism.”¹²⁸ Further, policymakers may prefer the “hidden subsidy” over the “open subsidy” out of fear that once the public is aware of the cost involved and can weigh the costs against benefits received by the tax incentive, the public will disfavor the incentive.¹²⁹ But this potential feature of tax incentives cannot be considered a positive attribute.¹³⁰ If a goal of government expenditures is to allocate limited funds where they can best be served, either by direct spending or through tax relief, such invisibility cannot be viewed

122. SURREY & MCDANIEL, *supra* note 108, at 100.

123. *See id.*

124. *See id.*

125. *Id.*

126. *Id.*

127. *Id.* at 104.

128. *Id.* (internal quotation omitted).

129. *See Surrey, supra* note 92, at 733-34. According to Surrey, “[t]he deeper the incentive is buried in tax technicalities and tax terminology, the more it looks like any other technical tax provision, [and] . . . the more desirable the tax incentive becomes. The public must dig hard and deep to find the subsidy and evaluate it.” *Id.* at 734.

130. *See id.*

as furthering this cause.¹³¹

3. Windfall Effect of Tax Incentives

Those opposed to tax incentives also argue that they are wasteful because a number of tax benefits are given to taxpayers for behaving the way they would have behaved without the benefit.¹³² Thus the tax incentive is a windfall to the taxpayer and does not stimulate the behavior desired by the government.¹³³

The windfall effect is likely demonstrated in the operation of the credit, particularly in private and foreign adoptions, where the bulk of adoptive families are middle- to high-income taxpayers.¹³⁴ Because the majority of individuals wishing to privately adopt are financially capable of paying the expenses without additional assistance, government spending lacks the desired effect of influencing behavior.

However, direct expenditure programs are also open to this criticism.¹³⁵ Surrey uses contract payments made to employers hiring unskilled employees as an example; these payments may be given to employers who would have hired the employees without the expenditure program.¹³⁶ The same would be true of direct spending programs to aid adoptive families. Families provided with free or reduced support services may have sought the services regardless of the price tag associated with them. Thus, the windfall effect can be considered a negative attribute of both tax incentives and direct expenditures.

4. Superior Expertise of Direct Expenditure Organizations

Under Surrey's analysis, direct spending programs are preferable to tax incentives in part because they are created and administered by individuals and agencies familiar with program objectives.¹³⁷ Such programs are generally analyzed by the congressional committee charged with the particular area of expertise.¹³⁸ In contrast, tax legislation is analyzed by the House Ways and Means Committee and the Senate Finance Committee, committees typically not involved in the substantive areas of proposed tax incentives.¹³⁹ Although these

131. *Id.*

132. *Id.* at 719.

133. *Id.*

134. GREEN, *supra* note 32, at 2 tbl.2.

135. Surrey, *supra* note 92, at 719.

136. *Id.*

137. SURREY & MCDANIEL, *supra* note 108, at 106.

138. See Surrey, *supra* note 92, at 728.

139. *Id.*

committees are “highly competent in tax matters, they do not have as much insight into these programs as the legislative committees normally handling the programs. A similar situation would prevail if the latter committees were suddenly to legislate on technical tax matters.”¹⁴⁰ The time and expense associated with ensuring that the committees are adequately informed add to the administrative cost of the incentive, and if sufficient information is not obtained, potentially decrease the effectiveness of the proposed legislation.¹⁴¹

However, Zelinsky offers a contrary view. He argues that even if direct expenditure organizations possess superior expertise “in the abstract,” the organizations are less likely than tax groups to make decisions “actually informed by such expertise.”¹⁴² This is due to the influence of interest groups on direct expenditure institutions.¹⁴³ Because tax policymakers are subject to “more numerous and diverse constituencies than the specialized, limited-clientele organizations that design and implement direct government spending,” they are less susceptible to, and dependent on, information provided by any particular lobbyist group.¹⁴⁴ Thus, although tax policymakers may possess inferior expertise in a substantive area, they are “better able to make decisions informed by the expertise they do possess” without interference from lobbyists.¹⁴⁵

While the soundness of this analysis is debatable, as interest groups seem to permeate all levels of government, it may reduce the importance of the superior expertise of direct expenditure institutions in tax expenditure analysis. This may be particularly true when considered in combination with recent technological advancements and the current ease of sharing information. Becoming knowledgeable in a specific area is considerably less time- and cost-consuming than it was forty years ago.

140. *Id.*

141. *See id.* at 728-29. A lack of expertise may also be seen at the administrative level. Social programs are normally administered by executive departments specializing in the area involved; tax collection is administered by the Internal Revenue Service (IRS), whose expertise is generally limited to tax matters. Because tax expenditures burden the IRS with administrative and enforcement responsibilities “outside of its traditional revenue collection function,” implementing new tax incentives is often more costly, and potentially less effective, than projected. Mary Heen, *Congress, Public Values, and the Financing of Private Choice*, 65 OHIO ST. L.J. 853, 911 (2004). Thus, under this analysis, efficient use of government funds aimed at promoting adoption would entail placing federal programs supporting adoptive families under the control and supervision of agencies familiar with their needs.

142. Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L.J. 1165, 1185-86 (1993).

143. *Id.*

144. *Id.* at 1166.

145. *Id.* at 1186.

5. Comparative Simplicity of Tax Incentives

Because tax incentives do not require the government to collect and then redistribute funds to the same degree that direct spending programs do, proponents of incentives argue that administration costs are far lower than the cost of direct spending programs.¹⁴⁶ Tax incentives are administered through an established framework; the Code is viewed as an effective mechanism already in place.¹⁴⁷ Thus, unlike the establishment of direct spending programs, tax incentives do not require new systems of administration, thereby reducing government costs.¹⁴⁸ Further, because tax incentives operate through the Code instead of through an array of varied government agencies, incentives require less government supervision, less bureaucracy, and less red tape.¹⁴⁹

However, numerous Code provisions which are considered tax incentives, such as I.R.C. § 23, are highly complex and can create problems for taxpayers and administrators.¹⁵⁰ These incentives involve complicated schedules and individuals often require the assistance of professional tax preparers to take full advantage of the benefit.¹⁵¹ Complicated eligibility requirements for receiving certain tax incentives, including the adoption credit, add to the complexities and potential confusion associated with the tax incentive approach.¹⁵² Each tax incentive is also an "additional item to be audited," increasing the cost of administration.¹⁵³ Thus, tape is often present in tax incentive programs, "and its color [is] red."¹⁵⁴

C. Policy Alternatives—Refundable Tax Credit

One approach to mitigating certain negative attributes of tax incentives, including the upside-down effect, is to offer them as credits against tax, which reduce tax liability dollar for dollar.¹⁵⁵ Under this framework, regardless of which tax bracket the taxpayer is in, the dollar benefit is the same, as long as the taxpayer's income does not exceed that allowed by the tax provision. In contrast, a tax credit is only beneficial if the taxpayer's tax liability is sufficient to utilize the

146. SURREY & MCDANIEL, *supra* note 108, at 100-01.

147. *Id.* at 108.

148. *Id.*

149. *See* Surrey, *supra* note 92, at 716.

150. *See id.* at 717-18.

151. *See id.*

152. *See id.*

153. SURREY & MCDANIEL, *supra* note 108, at 106.

154. *See* Surrey, *supra* note 92, at 718.

155. SURREY & MCDANIEL, *supra* note 108, at 108.

credit.¹⁵⁶ Drafters of the adoption tax credit attempted to curtail this result by allowing the taxpayer to carry forward any unused portion of the credit.¹⁵⁷ However, taxpayers in the lowest marginal brackets are unlikely to have enough tax liability to receive the full credit, even if they are allowed to carry it forward. Because lower income groups adopt a greater percentage of foster children than higher income groups, this is a large barrier to providing financial assistance to individuals adopting foster children.¹⁵⁸

Structuring the adoption tax credit as a refundable credit can remove this obstacle. The taxpayer would receive the full credit regardless of tax liability, thus in effect making the credit the equivalent of a direct grant to the taxpayer. While other direct assistance, such as access to free support services, could also eliminate barriers, a cash payment affords maximum flexibility for adoptive families. Flexibility and individual choice are necessary components of a successful program because the needs of foster children vary greatly.¹⁵⁹

A potential drawback to a refundable credit is its cost. Refundability results in greater accessibility to the tax credit, making it more costly to the government. However, this lost revenue is necessary to further the congressional goal of increasing the adoption of children from foster care by offsetting the cost. Because foster children are disproportionately adopted by lower income taxpayers, accessibility to the full amount of the credit without the necessary tax liability is warranted. In addition, increased adoptions from foster care have the potential to reduce the amount of government spending directed toward the foster care system.

Another drawback is the negative policy implication of “paying” individuals to adopt. While transforming the credit into a refundable credit ensures accessibility to the full amount of the credit, such an approach also amplifies policy concerns associated with “paying” families to adopt from the foster care system. Children are not likely to benefit when placed with parents whose primary motivation is a cash payment by the government. However, the amount of the one-time credit is undoubtedly small compared to the actual cost of raising a child. Further, all of the state safeguards in place to ensure children are

156. *Id.* at 109.

157. I.R.C. § 23(c) (2009).

158. GREEN, *supra* note 32, at 2.

159. According to Surrey, government assistance in the form of a refundable tax credit is equivalent to a direct spending program. SURREY & MCDANIEL, *supra* note 108, at 111. Surrey would argue that the credit should be included in the taxpayer’s income. If not, an additional tax expenditure arises, and the credit will have the same upside-down effect as a deduction or exclusion. *See* Surrey, *supra* note 92, at 723. To enhance the distributional fairness of the credit, the amount should be included in recipients’ taxable income. Because the tax liability of low-income taxpayers is small, inclusion of the credit should not have a significant deterrent effect.

adopted into secure homes, such as investigative home studies, background examinations, and personal interviews, would remain intact.¹⁶⁰

D. Elimination of the Credit for Adoptions Other than Special Needs Adoptions

Another policy alternative is to eliminate the credit entirely for private adoptions. Although one goal of EGTRRA was to “encourage more adoptions and allow more families to afford adoption,”¹⁶¹ the policy justification for subsidizing private adoptions is seemingly weaker than for promoting adoptions of special needs children, including those in foster care. On average, parents adopting through private and foreign adoptions have higher incomes than families adopting foster children, and, as noted above, two-thirds of the total dollars spent on the tax credit in 2005 were received by taxpayers with incomes of \$75,000 or greater.¹⁶² If the goal of the credit is to promote adoptions by making them more affordable, giving the benefit to high-income taxpayers who presumably already have the ability to pay makes little sense.¹⁶³

Using tax dollars to pay individuals to engage in behaviors that they would engage in without such an incentive is unpalatable, and it raises the question of whether the credit should be discontinued for adoptions other than those of special needs children. However, this policy choice disregards the importance lawmakers have placed on promoting the rearing of children who will grow up to become taxpayers. It also

160. An additional issue concerns the nature of the tax credit for private and foreign adoptions, and whether the credit for these types of adoptions should also be refundable. A uniform refundable credit for all adoption types would lessen any potential administrative burden and also protect against criticism by those only seeking to adopt privately. Further, private and foreign adoptions currently constitute over 80% of adoptions supported by the tax credit and account for a grossly disproportionate number of adoption credit recipients; thus, the majority of families adopting privately are already utilizing the credit, and the additional cost of making the credit refundable for these types of adoptions would be small. See GREEN, *supra* note 32, at 2 fig. 1. However, the reporting requirements should remain in effect for private and foreign adoptions; most of the expenses related to private adoptions are easily recorded, and individuals adopting through private organizations do not face the same reporting problems as adoptive parents of foster children. See H.R. REP. NO. 107-064, at 13 (2001). Individuals participating in private adoptions can therefore more easily provide the documentation required to obtain the credit.

161. H.R. REP. NO. 107-064, at 5 (2001).

162. GREEN, *supra* note 32, at 1.

163. Further, waiting lines for domestic private adoptions can be years in length, and foreign adoptions are becoming more popular, with waiting periods well exceeding a year in length. *Id.* at 4. Thus, the policy rationale of securing a home for waiting children does not seem to support subsidizing these adoptions, as the children are not the ones waiting.

overlooks the inability of some would-be parents to have children of their own.

If the costs of adoption were identical to those of childbirth, then continuing to subsidize adoption to a greater extent than childbirth would be unreasonable; after all, adoptive parents receive the same tax benefits as parents of natural children, including the child tax credit and dependency exemption.¹⁶⁴ But adoption costs are generally higher than those of childbirth.

Private adoptions, whether domestic or foreign, can range in cost from \$5,000-\$70,000, the bulk which goes toward registration and attorney's fees.¹⁶⁵ In contrast, although the overall average cost of an uncomplicated childbirth in the United States is \$8,802, the average amount actually paid out-of-pocket for traditional delivery is \$463, and Cesarean sections average \$523 (insurance and hospital discount agreements generally cover the balance of the costs).¹⁶⁶ The adoption credit recognizes this disparity and attempts to compensate for the difference.¹⁶⁷

While some argue that the Code already tolerates numerous disparities and inequities, many features of the Code, including its progressive rate structure, demonstrate the government's commitment to a certain leveling of the playing field. This seems to be a constructive recognition of, and effort to reduce, certain unavoidable inequalities inherent in any society. Thus, continuing the accessibility of the credit for private and foreign adoptions appears a reasonable choice.

However, reducing the phase-out range for the credit may be a practical policy alternative. The 2009 phase-out range begins for taxpayers with AGIs in excess of \$182,180, and the credit is completely phased out for taxpayers with AGIs of \$222,180 or more.¹⁶⁸ Policymakers could revert the phase-out to the pre-EGTRRA, SBJPA

164. INTERNAL REVENUE SERVICE, PUBLICATION 501 (2009), available at http://www.irs.gov/publications/p501/ar02.html#en_US_publink1000220868.

165. *Adoption Costs*, available at http://www.adoption-services.org/adoption/adoption_costs.htm (last visited Nov. 8, 2010).

166. THOMSON HEALTHCARE, THOMSON REPORT: THE HEALTHCARE COSTS OF HAVING A BABY (2007), at 1, 7 fig. 1 (2007), available at <http://www.MarchofDimes.com/files/Thomson.pdf>.

167. Interestingly, the Code does not treat fertility procedures to overcome an inability to have children similarly. The Code does not allow a credit, but only a deduction for medical expenses related to fertility procedures, and the deduction is only for the amount of expenses greater than 7.5% of the taxpayer's AGI. INTERNAL REVENUE SERVICE, PUBLICATION 502 (2009), available at http://www.irs.gov/publications/p502/ar02.html#en_US_publink1000178856. This difference in treatment may be related to the policy goal of placing children with families; offsetting the costs of fertility procedures does not seem to positively affect the placement of existing children in family settings.

168. See I.R.C. § 23(b)(2)(A) (2009).

range: beginning at an AGI of \$75,000 and completely phasing out for an AGI of \$115,000 or more.¹⁶⁹ This reduction could also help offset the cost of a refundable credit.

V. CONCLUSION

The adoption tax credit was designed to further two congressional objectives: to reduce financial barriers to all adoptions and to encourage the adoption of special needs children, such as those in the foster care system. Unfortunately, the adoption credit of I.R.C. § 23 is expensive and has been unsuccessful at achieving the congressional goal of promoting adoptions from foster care.

For the credit to successfully incentivize foster care adoptions, it must be structured in a way that it is accessible to lower-income taxpayers who do not have the requisite tax liability to claim the credit. This can be achieved by transforming the current credit into a refundable credit. With the sunset date quickly approaching, Congress must determine whether it should continue to allow millions in forgone revenue without the corresponding desired result, or whether it should consider implementing new spending alternatives that would effectively promote its objectives.

VI. ADDENDUM

Before publication of this Note, Congress passed the Patient Protection and Affordable Care Act (Health Care Act).¹⁷⁰ Although focused primarily on expanding access to affordable health care, the Health Care Act also addressed the adoption tax credit, increasing the maximum amount of the credit to \$13,170.¹⁷¹ Most importantly, the Health Care Act makes the credit refundable and moves the credit from I.R.C. § 23 to I.R.C. § 36C, a subpart relating to refundable credits.¹⁷² Thus, for the first time, adoptive families unable to previously utilize the credit will receive a cash refund from the government for their adoption expenses. On this point, Surrey would likely be proud of our policymakers.

While this change is laudable, the new provision is temporary, and

169. See Small Business Job Protection Act, Pub. L. No. 104-188, § 1807, 110 Stat. 1755, 1899 (codified as amended at 42 U.S.C. §§ 671, 674, 1996b (1996)).

170. Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 10909, 124 Stat. 119 (2010).

171. *Id.* § 10909, 124 Stat. at 1021. Changes are effective for tax years beginning after December 31, 2009. The credit is now found at 26 U.S.C. § 36(c) (2010). *Id.* at 1024.

172. *Id.* at 1022.

the Health Care Act merely delays EGTRRA's sunset date with respect to the credit by one year, until December 2011.¹⁷³ Thus, unless Congress again extends the sunset date or makes EGTRRA and the Health Care Act's amendments permanent, the adoption credit will revert to its pre-EGTRRA provisions.¹⁷⁴ As adoptive families celebrate the new Health Care Act, they may momentarily forget the looming sunset date, but policymakers must keep in mind the thousands of children waiting for a permanent solution.

173. *Id.* at 1023.

174. *Id.*