
Credit Carryforward Utilization: The Adoption Tax Credit

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This paper will focus on the carryforward feature of the adoption tax credit whereby unused credits due to lack of sufficient tax liability can be applied to future tax years. Assuming that taxpayers can quickly utilize their carryforwards, a credit carryforward is a viable alternative to refundability for taxpayers with low tax liability to receive full tax benefits. With refundability, a taxpayer receives the full credit even if the amount of the credit exceeds the taxpayer's tax liability. In contrast, a credit with a carryforward is limited to the taxpayer's tax liability each year. Therefore, there is no guarantee that the credit will be fully utilized by the taxpayer.

There are currently two Federal tax benefits for adoption: the adoption tax credit and an exclusion for employer-reimbursed adoption expenses.¹ From 1997-2001, a taxpayer was eligible for a 100-percent credit for the first \$5,000 (\$6,000 for a special needs child) in qualified adoption expenses. The limit for adoption tax benefits is per adoption, not per year. Qualified expenses do not include employer reimbursements, regardless of whether or not the reimbursements are excludable or taxable. The tax credit phased out for taxpayers with modified Adjusted Gross Income (AGI) over \$75,000, and taxpayers with modified AGI greater than \$115,000 received no credit. The tax credit is non-refundable, but unused credits can be carried forward and used during the 5 subsequent tax years. Employer reimbursements for qualified adoption expenses up to the legal limit are excludable from income.² The limits and phaseout for the exclusion are the same as for the adoption credit.³ Tax benefits for adoption are not allowed for stepparent adoptions. For 1997, some 36,375 returns claimed the adoption tax credit, while 2,937 returns reported employer-provided adoption benefits; over \$70 million in tax benefits were received in 1997 (U.S. Department of the Treasury, 2000).

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), beginning in the 2002 tax year, the phaseout range will begin at modified AGI

of \$150,000, and the credit will be completely phased out at \$190,000 modified AGI. The \$150,000-modified AGI starting point of the phaseout range will be indexed in future years, but the width of the phaseout range will remain at \$40,000. The per adoption limit for the tax credit and exclusion will be increased to \$10,000 (indexed) for special needs and non-special needs adoptions, and, beginning in 2003, the credit and exclusion for special needs adoptions will not be limited to qualified adoption expenses if expenses are less than \$10,000. And finally, the adoption credit will be allowed against the Alternative Minimum Tax.⁴

Carryforwards are not common for individual tax credits, and, therefore, previous studies have not focused on carryforwards.⁵ Credits for 100-percent of qualifying expenses are also rare. For example, the child and dependent care tax credit has a maximum credit rate of 35 percent of qualifying expenses beginning in 2003, and the low-income savers credit has a maximum credit rate of 50 percent for contributions made to such retirement savings programs as Individual Retirement Accounts.

As an alternative to refundability, a credit carryforward may mitigate the incentive to misclaim a refundable credit by requiring positive tax liability in future years for the carryforward credit to be claimed. In addition, a credit carryforward helps limit the adverse incentive effects from the interaction of refundability with a 100-percent credit, such as the adoption tax credit. For example, the lack of incentive for adopting parents to limit adoption expenses (up to the credit maximum) under the adoption credit would be exacerbated if the adoption tax credit was fully refundable. The credit carryforward option is also less expensive in terms of revenue costs (particularly in the years immediately following initiation of the credit) than a fully refundable credit.

A major issue for tax policy is the length of time necessary for taxpayers to fully utilize a carryforward credit. If a credit carryforward is able to fully deliver tax benefits to low-income taxpayers in a timely fashion,

other Federal tax credits may incorporate this feature in the future. For the adoption credit, if households suffer a temporary drop in income in the year of the adoption, perhaps from one spouse leaving the workforce to devote time to the adoption process, then the carryforward may be fully utilized in a short period of time. However, if adopting families with a carryforward continue to have little or no tax liability, then a carryforward credit is not an attractive alternative to refundability for these families.

The paper will investigate claims of 1997 adoption carryforward credits in 1998 and 1999. Using a special Internal Revenue Service (IRS) extract of all tax returns claiming the adoption credit for the 1997-1999 tax years, the cross-sectional data show that over 40 percent of 1997 carryforward credits are claimed after 1 year. The unedited data indicate that almost 90 percent of 1997 carryforward credits are claimed after 2 years. However, a closer examination of the data suggests that this percentage is biased upwards. Carryforward credits from 1997 in the 1999 data need to be adjusted downward due to reporting errors which could have occurred either at the taxpayer or the data processing level. And the carryforward credits in the 1997 data need to be adjusted upwards to account for returns with no tax liability in 1997 but which appear in later years. Both of these adjustments work in the direction of lowering the percentage of carryforward credits claimed after 2 years. After adjusting the data, we find that around 60 percent of 1997 carryforward credits are claimed after 2 years.

The paper is structured as follows. The first section describes the data, and the second section presents the tabulations of carryforward credit claims. The third section discusses issues involved with carryforwards, and the fourth section concludes.

◆ Data

Reliable data on total adoptions have not been systematically collected. The most recent comprehensive analysis found a total of around 127,000 children in 1992 (Flango and Flango, 1995).⁶ Around 40 percent of these adoptions were stepparent adoptions. The number of foreign adoptions is available from the State Department and the Immigration and Naturalization Service. For 1999, about 16,400 foreign children were adopted.⁷

Note that tax data should not be used for examining adoptions in general. First of all, stepparent adoptions are not eligible for tax benefits and, therefore, almost half of all adoptions that occur in a given year will not appear in tax data. Secondly, special needs adoptions may be fully funded by public agencies. Fully funded adoptions do not incur qualifying adoption expenses and are, therefore, ineligible for adoption tax benefits. For Fiscal Year 1998, about 36,000 children were adopted from the public foster care system.⁸ However, it is unknown how many of these adoptions were fully funded.⁹ Thirdly, adopting households with no current year tax liability only appear in tax data if they utilize the carryforward credit in future years. And finally, high-income households that adopt will not appear in tax data if they fall outside the phaseout range for adoption tax benefits. Overall, tax data can account for less than half of all adoptions that occur in a given year.

Federal tax benefits for adoption were effective beginning in Tax Year 1997. For 1997, only finalized adoptions were eligible for the credit. Therefore, households claiming the adoption credit for 1997 would not be expected to incur additional qualifying adoption expenses for these adoptions. Special IRS cross-sectional extracts of all returns filing Form 8839 in 1997, 1998, and 1999 were examined. These extracts contain unedited and unamended tax return information for most, but not all, entries on Form 8839. The tax data for 1997 and 1998 are described in more detail in U.S. Department of the Treasury (2000). For 1997, the IRS extract contains information on the amount of credit carried forward to future years. For 1998 and 1999, the IRS extract contains information on the amount of credit carried forward from 1997.

◆ Results

The basic analysis examines information from each separate cross-section so that there is no matching of returns across years. Table 1 shows that, for 1997 returns claiming the adoption credit, 14,923 returns had a positive credit carryforward to future tax years totaling just over \$30 million.¹⁰ So, 41 percent of returns filing a 1997 Form 8839 had a credit carryforward to future years. In 1998, some 11,257 returns reported a positive credit carryforward from 1997. Of the more than \$24

million in carryforward credits eligible to be claimed by these returns in 1998, about \$13.2 million were actually claimed in 1998 with the rest being carried forward to future years. The table shows that 6,011 returns in 1998 fully utilized their credit carryforwards from 1997.

The tabulation from the 1999 data shows that 12,348 returns showed a positive credit carryforward from 1997. Over \$28 million in carryforward credits were eligible to be claimed in 1999, and \$13.6 million were actually claimed. Of the returns with carryforward credits from 1997, some 6,076 fully utilized their credit carryforward in 1999. The corresponding data are broken out for special needs, foreign, and non-special needs/non-foreign adoptions in Table 1.

These tabulations of the cross-sectional data suggest that 81 percent of returns with a credit carryforward in 1997 fully utilize their carryforwards by 1999, and 89.5 percent of the carryforward credit from 1997 is claimed by 1999. The conclusion to be drawn from the cross-sectional tabulations would be that the credit carryforward is a very effective way to deliver adoption tax benefits to households with low tax liability in the base year. However, a closer examination of the raw cross-sectional data shows that the tabulations in Table 1 likely overstate the utilization of the credit carryforward.

If we assume the data from 1998 are correct, then the tabulations from the 1999 data are suspect.¹¹ For all adoptions, the difference between the number of returns showing a credit carryforward in 1997 and those fully utilizing the credit carryforward in 1998 leaves a maximum of 8,912 returns that could have shown a credit carryforward from 1997 for Tax Year 1999.¹² An analogous calculation for the amount of credit claimed shows that a maximum of \$16.82 million in carryforward credits from 1997 could have been claimed in 1999. This is much less than the 12,348 returns claiming over \$28 million carryforward credits in 1999 that appear in Table 1.

To investigate this issue, we will first focus on the 1999 data since the 1997 and 1998 data were previously edited for obvious mathematical errors in the preparation of U.S. Department of the Treasury (2000). Entry error is very possible since the Form 8839 for 1999 con-

tains five entries labeled "credit carryforward" to and from various years. This entry error could occur at the taxpayer or the data processing level. Since only finalized adoptions were eligible for the adoption tax credit in 1997, the carryforward credit from 1997 should not equal the carryforward credit from 1999 if a positive credit was claimed in 1999. Therefore, returns were deleted from the 1999 carryforward totals where the reported carryforward credit from 1997 equaled the calculated carryforward credit from 1999 to future years and a positive credit was claimed in 1999.¹³ Note that a misstatement of carryforward credits does not mean that the overall adoption credit claimed by the taxpayer is necessarily incorrect.

Next, some returns with a carryforward credit from 1997 did not appear in the 1997 data presumably because of no tax liability in 1997. These returns may represent "new" returns that should be added to the original 1997 data. The panel aspect of the data was used to identify returns which first appear in 1998 or 1999 showing a carryforward credit from 1997. These returns are summarized in Table 2.

Table 2 shows that over 5,000 returns reported a carryforward credit from 1997 that did not appear in the original 1997 cross-sectional data. Adding these to the 1997 totals increases the number of returns with a carryforward credit from 1997 by over 30 percent. The amount of carryforward credit from 1997 also increases by over 30 percent. The adjusted 1997 data and the adjusted 1999 data are presented in Table 3. Note that the adjusted 1999 data in Table 3 are around 80 percent of their corresponding values in Table 1.

With the adjusted data in Table 3 for 1997 and 1999, it is calculated that, for all adoptions, 52 percent of returns with a credit carryforward from 1997 fully utilize their carryforward by 1999, and 58 percent of the carryforward credit from 1997 is claimed by 1999. These values are much less than the corresponding values from Table 1.

An earlier calculation showed that the totals in Table 1 were suspect as the amount of potential carryforward credit in 1999 was not possible, given the 1997 and 1998 data. The adjusted data in Table 3 are now more rea-

sonable. For all adoptions, a similar calculation now suggests a maximum of 14,141 returns that could have shown a credit carryforward from 1997 for Tax Year 1999 and a maximum of \$27.95 million in carryforward credits from 1997 that could have been claimed in 1999.¹⁴ These values are greater than the 9,775 returns showing \$23.62 million in carryforward credits from 1997 in 1999.

As an exercise, the information in Table 3 is used to estimate the amount of carryforward credit from 1997 that will eventually be claimed by 2002, the last year that carryforward credits from 1997 can be claimed. The calculations in Table 3 show that 32 percent of carryforward credits from 1997 are claimed in 1998. Another 26 percent is claimed in 1999 so that 58 percent of carryforward credits from 1997 are claimed after two years. By maintaining the ratio of the decline from 1998 to 1999 ($26\%/32\%=.81$) for the percent of carryforward credits from 1997 claimed in subsequent years, then 21 percent is claimed in 2000, 17 percent in 2001, and the final 4 percent in 2002.¹⁵ Under this scenario, all carryforward credits from 1997 are claimed in the 5 subsequent years after the initial claim.¹⁶

◆ Discussion

There are a few caveats to be noted for the analysis presented here. First, even with the adjustments from Table 2, the 1997 data continue to be understated. The amount of carryforward credit from 1997 will naturally increase when data from further years are available. The tabulations in Table 2 do show a decrease in the carryforward credit from 1997 for all adoptions as we move from returns that first appear in 1998 to returns that first appear in 1999.¹⁷ And it is reasonable to expect this trend to be non-linear for 2000-2002 because the 2000 tax year will be the third year since the original 1997 credit could be claimed. The number of returns with a carryforward credit from 1997 first appearing in 2000 should be small so that the increase may be minimal.¹⁸

Also, the data as presented in Table 2 contain returns that cannot be matched to a 1997 return by the Taxpayer Identification Number (TIN) of the primary taxpayer. For matching purposes, if there is any error in the reporting of the TIN in the unedited tax data, a re-

turn may erroneously appear in Table 2. Therefore, a return in Table 2 may not represent a "new" 1997 return and should not be added to the 1997 totals in Table 3.¹⁹ Unfortunately, there is no simple procedure to determine if a TIN is being misreported, and it is assumed that returns in Table 2 all represent new returns for the 1997 totals in Table 3. The caveat that not all returns in Table 2 represent new returns will offset some of the understatement of carryforward credits from 1997 mentioned in the preceding paragraph.

With a credit carryforward, the taxpayer must take care to keep track of unused credits over time. In the specific case of the adoption credit, adoptions in different years can further complicate matters since the taxpayer must keep track of carryforward credits from different base years. Claiming a carryforward for the adoption credit will only become more confusing as carryforward credits from more years are possible. Great care is needed in designing the carryforward to minimize taxpayer burden and confusion. Instructions for the taxpayer need to be simple and clear to avoid taxpayer confusion as much as possible. For example, taxpayers may mistakenly believe that the phaseout applies in the year a carryforward credit is claimed. Actually, the phaseout only applies in the year of the initial claim. And while a misstated carryforward credit does not necessarily lead to an incorrect overall credit claim by a taxpayer, complex and confusing items increase the likelihood that mistakes will be made. One option is for the IRS to calculate and inform the taxpayer of any carryforward credit so that he or she does not have to track down previous tax returns to determine the credit carryforward.²⁰

◆ Conclusion

This paper has examined the amount of carryforward adoption credits utilized in the 2 years after the credits were originally available. The results will help in the design and implementation of credit carryforwards for other provisions in the future. For example, it needs to be determined whether the benefits of using a carryforward credit to deliver tax benefits outweigh the added complexity in tax returns for low- and moderate-income taxpayers.

Using special IRS tax return data from 1997-1999, the aggregate data show that almost 90 percent of carryforward credit dollars from 1997 are utilized by 1999. However, an examination of the raw data suggests that utilization of the credit carryforward is biased upwards. The analysis suggests two sources of the bias: misreporting of carryforward credits from 1997 in 1999, and an understatement of the amount of carryforward credits in 1997. The former is due to entry error, while the latter is due to tax returns which do not appear in the original 1997 data because they lack any 1997 tax liability. After making adjustments to the data, it is estimated that about 60 percent of adoption carryforward credit dollars from 1997 are utilized by 1999.

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◆ References

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National Council for Adoption (1999), *Adoption Factbook III*, Park Press Quality Printing.

U.S. Department of the Treasury (2000), *Report to The Congress on Tax Benefits for Adoption*.

◆ Footnotes

- [1] Information on the adoption credit and exclusion is provided on Form 8839.
- [2] Amounts excluded are still subject to Social Security and Medicare taxes.

- [3] For the exclusion, modified AGI includes all employer payments and reimbursements for adoption expenses.
- [4] For more on Federal tax benefits for adoption, see U.S. Department of the Treasury (2000).
- [5] The District of Columbia First-Time Homebuyer Credit is another tax credit with a carryforward feature.
- [6] The National Council for Adoption periodically conducts a survey of adoptions. They estimate that 120,000 children were adopted in 1996 (National Council for Adoption, 1999).
- [7] See http://www.travel.state.gov/orphan_numbers.html.
- [8] See http://www.calib.com/naic/pubs/s_foster.htm, accessed 2-19-2002.
- [9] The proportion of fully funded special needs adoptions is likely to be high. Less than 4,000 special needs adoptions received tax benefits for 1997 (U.S. Department of the Treasury, 2000). Households adopting special needs children are typically low- to moderate-income households and may have no current year tax liability even if the adoption is not fully funded.
- [10] To be clear, over \$70 million in adoption tax benefits were received in 1997. In addition, over \$30 million in adoption tax credits were carried forward to future years.
- [11] As described in U.S. Department of the Treasury (2000), the 1997 and 1998 results were based on data which were edited for obvious errors. Form 8839 for 1998 is much simpler than for 1999 in terms of the carryforward credit because any carryforward credit must come from 1997.
- The data for special needs adoptions are clearly incorrect. The number of 1999 returns claiming a carryforward credit from 1997 (1,329) is greater

than the number of 1997 returns with a carryforward credit to future years (1,155).

[12] 14,923 minus 6,011=8,912.

[13] Imposing the additional requirement that deleted returns show no new adoption expenses to account for adoptions after 1997 did not result in fewer deletions.

[14] 20,152 minus 6,011=14,141.

[15] For example, $26\% \times .81 = 21\%$ for 2000.

[16] Unfortunately, for Tax Year 2000, Form 8839 contains only an entry for carryforward credits to 2000 instead of assigning carryforward credits from previous years. This will make it difficult to determine how many carryforward credits from 1997 are claimed for Tax Year 2000.

[17] Table 2 shows that the number of new returns for special needs adoptions actually increases from 1998 to 1999. This may not be surprising since households adopting special needs children tend to be low- to moderate-income families and are more likely to have no tax liability against which to take the carryforward credit.

[18] Footnote 16 details why it will not be possible to determine the carryforward credit from 1997 in Tax Year 2000 returns.

[19] If returns in Table 2 represent "new" returns which did not appear in the 1997 data, the IRS would generally require the taxpayer to file an amended 1997 return for the carryforward credit from 1997 to be valid. The IRS data studied here do not contain amended returns.

[20] I would like to thank Mike Udell for this suggestion.

Table 1. Unadjusted Cross-Sectional Adoption Credit Data

	All Adoptions		Special Needs Adoptions		Foreign Adoptions		Non-Special Needs Non-Foreign Adoptions	
	Returns (number)	Amount (\$000s)	Returns (number)	Amount (\$000s)	Returns (number)	Amount (\$000s)	Returns (number)	Amount (\$000s)
1997 Credit Carryforward to Future Years	14,923	\$30,046	1,155	\$2,792	5,767	\$13,673	8,001	\$13,581
1998 Returns with Credit Carried Forward from 1997	11,257	\$24,285	838	\$2,138	3,822	\$9,690	6,597	\$12,457
Amount of Carryforward Claimed in 1998		\$13,226		\$1,183		\$5,617		\$6,426
Number of Returns Fully Utilizing Carryforward	6,011		405		2,165		3,441	
1999 Returns with Credit Carried Forward from 1997	12,348	\$28,095	1,329	\$3,514	3,636	\$9,623	7,383	\$14,958
Amount of Carryforward Claimed in 1999		\$13,666		\$1,447		\$5,245		\$6,974
Number of Returns Fully Utilizing Carryforward	6,076		511		2,013		3,552	
Total Returns Fully Utilizing Carryforward by 1999	12,087		916		4,178		6,993	
Amount of Carryforward claimed by 1999		\$26,892		\$2,630		\$10,862		\$13,400

Table 2. Returns showing a carryforward credit from 1997 which did not appear in the original 1997 data

	Returns (number)	Amount of Carryforward from 1997 (\$000s)
All Adoptions		
Returns appearing in 1998, but not 1997	2,817	\$ 5,985
Returns only appearing in 1999	2,412	\$ 5,147
Special Needs Adoptions		
Returns appearing in 1998, but not 1997	294	\$ 695
Returns only appearing in 1999	329	\$ 730
Foreign Adoptions		
Returns appearing in 1998, but not 1997	807	\$ 2,088
Returns only appearing in 1999	543	\$ 1,648
Non-Special Needs/Non-Foreign Adoptions		
Returns appearing in 1998, but not 1997	1,716	\$ 3,201
Returns only appearing in 1999	1,540	\$ 2,769

Table 3. Adjusted 1997 and 1999 Adoption Credit Data

	All Adoptions		Special Needs Adoptions		Foreign Adoptions		Non-Special Needs Non-Foreign Adoptions	
	Returns (number)	Amount (\$000s)	Returns (number)	Amount (\$000s)	Returns (number)	Amount (\$000s)	Returns (number)	Amount (\$000s)
ADJUSTED 1997 Credit Carryforward to Future Years	20,152	\$41,178	1,778	\$4,217	7,117	\$17,409	11,257	\$19,551
1998 Returns with Credit Carried Forward from 1997	11,257	\$24,285	838	\$2,138	3,822	\$9,690	6,597	\$12,457
Amount of Carryforward Claimed in 1998		\$13,226		\$1,183		\$5,617		\$6,426
Number of Returns Fully Utilizing Carryforward	6,011		405		2,165		3,441	
ADJUSTED 1999 Returns with Credit Carried Forward from 1997	9,775	\$23,622	1,057	\$2,938	2,894	\$8,067	5,824	\$12,617
Amount of Carryforward Claimed in 1999		\$10,766		\$1,122		\$4,179		\$5,465
Number of Returns Fully Utilizing Carryforward	4,401		359		1,493		2,549	
Total Returns Fully Utilizing Carryforward by 1999	10,412		764		3,658		5,990	
Amount of Carryforward claimed by 1999		\$23,992		\$2,305		\$9,796		\$11,891