



## Legislative Fiscal Bureau

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TO: Members  
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Senate Substitute Amendment 1 to Senate Bill 408: Adoption Tax Credit

Senate Bill 408 would provide a credit against the individual income tax for certain adoption expenses. SB 408 was introduced on January 27, 2004, and referred to the Senate Committee on Health, Children, Families, Aging, and Long Term Care. On February 17, 2004, that Committee recommended passage of Senate Substitute Amendment 1 to SB 408 on a vote of 5 to 4. The substitute amendment was referred to the Joint Committee on Finance on February 26, 2004.

### **BACKGROUND**

#### **Federal Adoption Expenses Credit**

For tax year 2004, federal law allows taxpayers to claim an individual income tax credit of up to \$10,390 for qualified adoption expenses for each eligible child. Taxpayers who adopt a child with special needs may claim an adoption credit of \$10,390 regardless of actual expenses paid or incurred in the year the adoption becomes final. The credit is phased out for taxpayers with modified adjusted gross income (AGI) over \$155,860, and no credit is allowed to taxpayers with a modified AGI of \$195,860 or more. The amount of qualified adoption expenses and the modified AGI amount for the purpose of phasing out the adoption credit are adjusted for inflation each year. The credit is not refundable, but unused credits may be carried forward for up to five years to offset future tax liabilities.

"Qualified adoption expenses" include reasonable and necessary adoption fees, court costs, attorney fees, and other expenses that are directly related to the legal adoption of an eligible child. Expenses incurred in violation of state or federal law or in connection with the adoption of a child

of the taxpayer's spouse are not eligible for the credit. Costs associated with a surrogate parenting arrangement are also ineligible for the credit.

An "eligible child" is an individual who has not attained the age of 18 as of the time of the adoption or who is physically or mentally incapable of caring for himself. A child with special needs is any child who cannot or should not be returned to the home of his or her parents and a specific factor or condition makes it reasonable to conclude that the child cannot be placed with adoptive parents unless assistance is provided, as determined by a state. Also, to qualify as a child with special needs, the child must be a citizen or resident of the U.S. The qualified adoption expense of a child, regardless of need, who is not a U.S. citizen or resident will not qualify for the adoption credit unless the adoption is final.

If adoption expenses are paid during a tax year prior to the tax year in which the adoption is finalized, the credit is allowed during the year the adoption is finalized. If adoption expenses are paid during or after the tax year in which the adoption is finalized, the credit is allowed for the tax year in which the expense is paid or incurred.

Taxpayers may not claim the credit for any expense for which another deduction or credit is allowed. This includes amounts excluded from gross income that are paid or incurred by an employer for the employee's qualified adoption expenses pursuant to an adoption assistance program. However, any adoption expenses incurred in excess of the amount provided under an employer's adoption assistance program may be used to claim the adoption credit.

### **Current State Income Tax Deduction for Adoption Expenses**

Current state law allows a deduction from AGI under the individual income tax for adoption fees, court costs, or legal fees relating to the adoption of a child, for whom a final order of adoption has been entered in a Wisconsin court during the taxable year. The maximum amount that may be deducted is \$5,000, and the deduction is available for amounts expended during the period that consists of the year to which the claim relates and the prior two taxable years. The deduction only is allowed for full-year residents who are adoptive parents. It is estimated that the deduction reduces state individual income taxes by approximately \$200,000 per year.

### **SUMMARY OF SUBSTITUTE AMENDMENT 1**

SSA 1 to SB 408 would eliminate the current state income tax deduction for adoption expenses for tax years that begin after December 31, 2004.

Instead, beginning in tax year 2005, the substitute amendment would create a state adoption expenses credit under the individual income tax. The credit would be available to individuals who are eligible for, and claim, the federal tax credit for adoption expenses.

The state credit would be allowed for qualified adoption expenses, to the extent that those expenses exceed the amount of the credit for which a claimant is eligible, and claims, under the

federal credit in the year to which the claim relates. However, the amount claimed for the state credit could not exceed \$5,000. The credit would not be refundable, but unused credits could be carried forward for up to five years to offset future income tax liabilities.

No credit would be allowed unless it is claimed within four years of the unextended due date of the tax return relating to the year for which the credit is claimed. The credit would be prorated for nonresidents and part-year residents based on the ratio of the taxpayer's Wisconsin AGI to federal AGI. Federal provisions relating to the adoption expenses credit would also apply to the state credit, unless the state provisions explicitly provide otherwise.

The Department of Revenue would be authorized to enforce the state adoption credit and could take any action, conduct any proceeding, and proceed as it is authorized in respect to income taxes. The income tax provisions relating to assessments, refunds, appeals, collection, interest, and penalties would also apply to the adoption credit.

## **FISCAL EFFECT**

According to the Department of Health and Family Services (DHFS), there were approximately 500 international adoptions by Wisconsin residents in 2002, at an average cost of \$18,000 to \$30,000. In addition, there were an estimated 746 domestic adoptions by Wisconsin parents, which are estimated to cost in excess of \$15,000. Therefore, it is estimated that 1,246 adoptions would have qualified for the \$5,000 maximum state credit in that year. Staff at DHFS believes that international adoptions will increase by about 10% annually, assuming continued access by Americans to children in foreign countries. The number of domestic adoptions is expected to remain steady. There were also over 1,000 public adoptions (children who were in foster care and adopted) and step-parent adoptions in Wisconsin in 2002. However, out-of-pocket costs associated with public adoptions are estimated to be well below the \$10,390 amount allowed under the federal credit, and step-parent adoptions are not eligible for the federal credit. Therefore, these types of adoptions would not be eligible for a state credit under the substitute amendment.

Based on this data, it is estimated that the substitute amendment would reduce individual income tax revenues by \$6.8 million in 2005-06. Over the next four years, the estimated cost of the credit would increase to \$7.1 million in 2006-07, \$7.5 million in 2007-08, \$7.9 million in 2008-09, and \$8.3 million in 2009-10. These estimates assume that 75% of the total allowable credits would be claimed in the year in which the adoption was finalized and that the remaining 25% would be claimed in the following year. They also account for anticipated growth in international adoptions.

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