

Income Tax Benefits of Adoption

By David Gossett, CPA, CFP

My purpose in writing about this issue is to help parents understand the substantial tax benefits that our government provides for them. In most cases, the tax savings can amount to thousands of dollars, which can benefit adoptive families greatly. This could allow some families to afford the expense or avoid going into debt. Adoptive parents can use their W-4 Form (with employers) or estimated tax (self-employed) provisions to retain tax monies during the year to assist in financing their adoption. Caution should be exercised regarding the timing of anticipated credits and the reduction of tax payments, because we all know that delays are unavoidable in this process. A tax professional should be consulted if you need help.

Adoptive parents may be able to take adoption expense tax credit and/or adoption assistance exclusion. Both a credit and exclusion can be claimed for the same adoption; however, both cannot be claimed for the same expense. File Form 8839, Qualified Adoption Expenses, to claim the credit or exclusion.

New Law 2001 Tax Act

Beginning in 2002, the credit and the exclusion will be **permanent provisions** for all adoptions of eligible children. Under prior law, the credit and exclusion were scheduled to sunset for expenses paid or incurred after 2001, with an exception for adoptions of children with special needs.

Dollar limitation increased and indexed for inflation: Beginning in 2002, the dollar limitation is increased to **\$10,000 for each eligible child**, regardless of whether or not the child has special needs. The \$10,000 limitation amount will be indexed for inflation after 2002.

AGI limitation increased and indexed: Beginning in 2002, the credit and exclusion begins to be phased-out for taxpayers with modified AGI (adjusted gross income) over \$150,000 and is finished phasing out for those with AGI over \$190,000. The beginning phase out amount of \$150,000 will be indexed beginning after 2002.

Special needs child: Beginning in 2002, the credit for an adoption of a special needs child is only allowed in the year that the adoption becomes final (expenses paid in prior years are allowed in the final year). Beginning in 2003, a \$10,000 credit or exclusion is allowed for the adoption of a special needs child even if the taxpayer does not have that amount of qualified adoption expenses. **Caution:** This “extra” credit provision only appears to be available for adoptions of US Citizens or residents.

Qualifying Individual

An eligible child must be:

- Under age 18, or
- Physically or mentally incapable of caring for himself/herself.

An eligible special needs child must be:

- Citizen or resident of U.S. (including U.S. possessions), and

- State must determine the child cannot, or should not be returned to parents' home, and unless adoption assistance is provided to the adoptive parents, the child will probably not be adopted due to a specific factor or condition. Example of Factors/Conditions: Child's ethnic background, age, and membership in a minority or sibling group, medical condition, or physical, mental or emotional handicap.

Qualified Adoption Expense

Expenses include reasonable and necessary adoption fees, court costs, attorney fees, traveling away expenses while away from home and other expenses directly related to the legal adoption of an eligible person.

Dollar Limitation:

- The tax credit plus the exclusion equals 100% of qualified adoption expenses.
- Maximum credit and exclusion of \$5,000 for each effort to adopt an eligible child (up to \$6,000 for each special needs child). The limit is a per child limit, not an annual limit. Maximum credit and exclusion increase to \$10,000 after 2001 and are indexed for inflation after 2002.
- Limits apply separately to credit and exclusion if both are taken.
- Limits cumulative over all taxable years for the same adoption effort.
- Expenses of an unsuccessful adoption are combined with expenses of a later successful adoption for dollar limits (\$5,000 or \$6,000 for 2001, \$10,000 for 2002).

AGI Limitation:

Credit and exclusion are phased out for taxpayers with modified AGI between \$75,000 and \$115,000. Beginning phase-out amount increases to \$150,000 after 2001 and is indexed for inflation after 2002 AGI phase-out is applied only in the year the adoption credit is generated, and is not applied in future years to reduce any credit carryovers.

Tax Year Credit Can Be Taken

Foreign Adoption: [Internal Revenue Code Sec. 23(e)]

- Credit available only if foreign adoption is final.
- Expenses paid in a year before or during the year the adoption is finalized: The credit is allowed in the year the adoption is finalized.
- Expenses paid in a year after adoption is finalized: The credit is allowed in the year of payment.

Tax Year Exclusion Can Be Taken

Exclusion is a provision whereby your employer may pay for some or all of qualified adoption expenses and you do not have to include such amounts in your income.

Foreign adoption:

- Exclusion is available only if your foreign adoption is final.
- Expenses paid in a year prior to or during the year adoption is finalized are allowed to be excluded from income.
- Expenses paid in a year after adoption is finalized are also allowed the exclusion for the year of payment.

My thanks to the publishers of Income Tax & Financial Planning © 2001 TMI Tax Services, Inc. Minnetonka, MN for concise and descriptive explanations, which I used extensively for this article.

Additional information: See IRS Publication 968 available at the IRS Publications Web Site:
www.irs.ustreas.gov/prod/forms_pubs/pubs.html

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