

## TAX BENEFITS FOR ADOPTION: THE ADOPTION TAX CREDIT\*

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### **Introduction**

Adoption is a long and often emotionally laborious process. One of the many stressors for families is the financial challenge of adopting. Since its inception in 1997, the adoption tax credit has helped many thousands of middle-income American families defray the high costs of adoption, making adoption a reality and providing loving, permanent families for millions of children who might have otherwise languished in foster care or institutions.

### **History**

After years of advocacy by adoption organizations, including the National Council For Adoption (NCFA), the Federal Adoption Tax Credit went into effect for tax year 1997. This initial adoption assistant program was part of the 1996 Small Business Job Protection Act and set the maximum credit at \$5,000 per child (\$6,000 per child with special needs), and allowed for the

credit to sunset (expire) on December 31, 2001.

In 2001, Congress passed parts of President Bush's tax incentive package, the Economic Growth and Tax Relief Reconciliation Act of 2001.<sup>1</sup> This act extended the adoption tax credit until December 31, 2010 and increased the initial maximum credit to \$10,000 per child (for both special needs and non-special needs adoptions) and also indexed this amount for inflation annually. The process of indexing the credit allows for adjusting the maximum allowed amount annually for inflationary factors as they pertain to adoption and the economy. The credit for adopting a child with special needs was made permanent with this act. For 2010, the indexed tax credit maximum was \$13,170 per child.<sup>2</sup>

### **Where Things Currently Stand**

The adoption tax credit as provided for in the 2001 legislation was set to sunset in tax year

\*This information is provided for general educational purposes and is not meant as tax advice. This is a general summary and does not cover every specific tax issue and is not inclusive of every situation. You should consult a competent tax adviser for individual advice regarding your own situation.

<sup>1</sup> Economic Growth and Tax Relief Reconciliation Act of 2001. Pub. L. No. 107-16 (2001).

<sup>2</sup> IRS. (2009). *Expansion of adoption tax credit*. Retrieved from <http://www.irs.gov/formspubs/article/0,,id=177982,00.html>

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2010 unless it was renewed by Congress. The Patient Protection and Affordable Care Act of March 2010 temporarily increased the adoption expense credit and fringe benefit exclusion limit for adoption assistance programs and made the credit refundable. The changes are effective for tax years beginning after Dec. 31, 2009.

This extension allows for the maximum adoption credit to be increased to \$13,170 per eligible child. This increase applies to both non-special needs adoptions and special needs adoptions. Also, the adoption credit is made refundable, meaning that families will realize the full benefit regardless of taxes paid. The scheduled sunset relating to the adoption credit is delayed for one year (i.e., the sunset becomes effective for tax years beginning after Dec. 31, 2011).

On December 17, 2010 the 2010 Tax Relief Act was signed into law which extended the Bush era tax cuts through tax year 2012. The extension for tax year 2012 is not refundable as it is with the Patient Protection and Affordable Care Act which only applies for tax years 2010 and 2011.

If the adoption tax credit is allowed to expire after this current extension, the maximum tax credit for the adoption of children with special needs would decrease to \$6,000 per child, with the credit for adoptions of non-special needs children expiring altogether.

## Adoption Tax Credit

For the tax year 2010, the maximum adoption tax credit was \$13,170 per child for qualified adoption expenses. The tax credit phase-out began for taxpayers with a modified adjusted gross income (AGI) in excess of \$182,180, and was completely phased out for taxpayers with a modified AGI of \$222,180 or higher.

The Internal Revenue Code §23(a)<sup>3</sup> defines the adoption tax credit as follows: “In the case of an individual, there shall be allowed a credit against the tax imposed by this chapter the

amount of the qualified adoption expenses paid or incurred by the taxpayer.”

Furthermore, the Code defines “Qualified Adoption Expenses” to be “reasonable and necessary adoption fees, court costs, attorney fees, and other expenses which directly relate to, and the principle purpose of which is for, the legal adoption of an eligible child by the taxpayer.”

Examples of qualified expenses include fees paid to an adoption agency, legal fees, travel-related expenses, all official costs, and any other reasonable cost associated with adopting the identified child. Excluded expenses include any expenses deemed illegal by State or Federal Statute, expenses for surrogate parenting arrangements, expenses related to step-parent adoption, or expenses reimbursed through grants or employer assistance programs.

The Code further defines an “eligible child” to be “an individual who has not attained age 18 or is physically or mentally incapable of caring for himself.” To apply for the credit, married couples must file a joint return and the maximum credit limits are the same for both married couples and single adoptive parents.

The adoption tax credit differs from a deduction, exclusion, or exemption in that it actually reduces, dollar-for-dollar, the taxpayer’s tax liability by subtracting the amount from taxes owed. A tax credit is specifically different from a deduction, in that while a tax credit offsets a taxpayer’s tax liability, a deduction offsets income from a taxpayer’s adjusted gross income to come to taxable income (the amount of income taxable). Therefore, a tax credit is much more advantageous than a deduction, because the tax credit is a refund of applicable taxes to offset the cost of adoption. More simply, an adoptive parent’s tax dollars go to fund approved adoption expenses rather than the federal government.

With the exceptions of tax years 2010 and 2011, the adoption tax credit has historically been

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<sup>3</sup> For a copy of the tax code referenced throughout this document, see: <http://www.law.cornell.edu/uscode/26/23.html>



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nonrefundable, allowing for a five year carry-forward for those portions within the maximum allowed amount not able to be utilized in the taxable year in which the credit arose. The carry-forward is applicable for future tax years even if the taxpayer's modified AGI in those years exceeds the amount allowable or extends into the phase-out range. The carry-forward credit must be used within four subsequent years of the taxable year in which the adoption occurred.

As previously stated, for tax years 2010 and 2011, the tax credit was made refundable by The Patient Protection and Affordable Care Act of March 2010, meaning that regardless of the taxes paid, families will be able to receive the maximum allowed benefit in the year of finalization.

Furthermore, for taxpayers who has finalized adoptions before tax year 2010, yet had applicable carryforwards from previous credits, these taxpayers remaining credit will be fully refundable in tax year 2010.

The IRS Code also defines in which tax year the credit becomes applicable, which differs slightly for domestic and some international adoptions. If the child is "a United States Citizen or a child who is foreign born, but who is a resident at the time the adoption commences," the taxable year for which the adoption tax credit can be claimed is the year in which the adoption became finalized. Simply put, once you have received the final adoption decree from the court, you may claim the credit in that tax year. Any expenses paid prior to this filing are eligible as if incurred in the tax year the decree is entered. This is also applicable for those families who adopt their child on a legal guardianship decree from the country of origin or any family whose child enters the country on an IR-4 visa. The credit is applicable once an adoption is finalized in the United States.

In the case of adoptions for which The Hague Convention determines the finality of the adoption, the IRS will accept that declaration of finality for the purposes of allowing the tax credit. For those international adoptions not under the auspices of The Hague, finality is determined

when the competent authority in the sending country enters a decree of adoption or the adoption is finalized in the home state of the adopting parents.

For additional expenses that may occur in subsequent years pertaining to an adoption that occurred in a previous tax year, the taxpayer may claim those expenses in the tax year they are incurred, as long as the total amount claimed is within the maximum allowable amount per child. For families who are adopting multiple children, it is important to understand that the maximum amount is *per child*; therefore, families are able to claim a credit for each child adopted, even if such adoptions take place in the concurrent tax year.

*An example of the application of the tax credit:* John and Jane Doe adopt a child in 2009. John and Jane incur \$20,000 in eligible adoption expenses. In 2009 their tax liability on their Form 1040 was \$15,000, and they had \$13,500 withheld from their paychecks during the year. In a normal year, without the adoption tax credit, they would expect to pay \$1,500 to the Federal government before April 15. However, with the maximum adoption tax credit they are permitted to take (\$12,150), their tax liability is reduced to \$2,850, which means they will receive a refund of taxes withheld of \$10,650. Instead of paying the government in taxes, their tax dollars were applied to their adoption.

The tax credit and subsequent carry-forward is especially beneficial to lower-income and middle-income families, in that any part of the credit not taken in year one may be carried forward for five years. This helps families plan their adoption expenses with loans that can be repaid as taxes are offset during subsequent years. Families can thus make lump-sum payments towards the loans, in effect paying them off faster, while reducing the amount of interest paid.

*An example of application of the carry-forward:* John and Jane Doe adopt a child in 2009. John and Jane incur \$15,000 in eligible adoption expenses. In 2009 their tax liability on their Form 1040 was \$6,000, and they had \$5,000 withheld



from their paychecks during the year. In a normal year, without the adoption tax credit, they would expect to pay \$1,000 to the Federal government before April 15. However, with the adoption tax credit they are permitted to take, their liability is reduced to \$0, which means they will receive a refund of taxes withheld of \$5,000. Instead of paying the government in taxes, their tax dollars were applied to their adoption. Since they only used \$5,000 of the tax credit in 2009, they have \$7,150 to carry forward to offset tax liability in 2010.

## Adopting a Child with Special Needs

The designation of “Child with Special Needs” only applies to children who are U.S. citizens. A child qualifies as a “Child with Special Needs” if the taxpayer adopts a child who has been deemed by the State to qualify for adoption subsidy assistance (State assistance or SSI). The taxpayer may claim the entire credit after adopting a child from U.S. foster care or a child who is a U.S. citizen who has been deemed to have special needs by a competent American authority, even if the expenses they incurred were less than the maximum amount (\$12,150 for 2009).

*An example of this special needs application:* John and Jane Doe adopt a child from foster care in 2009. John and Jane incur \$2,500 in eligible adoption expenses. In 2009 their tax liability on their Form 1040 was \$14,000, and they had \$13,000 withheld from their paychecks during the year. Although their qualified adoption expenses were only \$2,500, John and Jane are still eligible to take the entire \$12,150 tax credit, reducing their tax liability to \$1,850. John and Jane will receive a refund of taxes withheld of \$11,150.

## Adoption Tax Exclusion

As previously stated, the taxpayer must exclude amounts reimbursed via an employer program or otherwise when determining qualified

adoption expenses for the purpose of the adoption tax credit. There is, however, a provision in the Code (IRC §137)<sup>4</sup> that provides an exception for income received through an employer adoption assistance program. It states: “gross income of an employee does not include amounts paid or expenses incurred by the employer for qualified adoption expenses in connection with the adoption of a child by an employee if such amounts are furnished pursuant to an adoption assistance program.”

The definition for qualified adoption expenses is the same as that used for the adoption tax credit, and the maximum exclusion amount and phase-out limits apply as those set forth for the credit. With the costs associated with adoption and the varied companies supplying adoption assistance programs to their employees, this exclusion can potentially save a family as much as \$3,500 in taxes.

## Failed Adoptions

The Code does not include specific language to indicate that taking a credit is allowable for a failed adoption attempt. It also does not specify that the credit be taken only for successful adoption efforts. The only direct recognition of failed adoption attempts is found in the filing requirements, which note that the taxpayer may or may not know the name and age of the child for whom the credit is claimed. Furthermore, in the instructions for filling out Form 8839, the form that accompanies the 1040, on which the taxpayer claims the adoption tax credit, it states, “Complete all columns that apply to the eligible child you adopted or *tried to adopt.*”

Currently there are no clear requirements and no clear guidelines from the IRS that make it clear the adoption effort must have been successful to be eligible for the credit. If a taxpayer has experienced an unsuccessful adoption of an identified child and incurred qualified adoption expenses, it is highly recommended that they

<sup>4</sup> See: [http://www.taxalmanac.org/index.php/Internal\\_Revenue\\_Code:Sec.\\_137.\\_Adoption\\_assistance\\_programs](http://www.taxalmanac.org/index.php/Internal_Revenue_Code:Sec._137._Adoption_assistance_programs)



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seek professional help from a local CPA for guidance on how to best claim the credit for the qualified adoption expenses.

## **Other Tips for Adoptive Parents, Forms, and Suggestions**

Once the taxpayer(s) have experienced a successful adoption, they should claim their child as a dependent on their tax return for the tax year the child entered the home. The child will need a Taxpayer Identification Number, which can be either the child's Social Security Account Number or an Adoption Taxpayer Identification Number (ATIN) (this can be applied for by using Form W-7A). This form requires approximately four to eight weeks for processing and expires on the two-year anniversary of its issuance or the issuance of the Social Security Account Number, whichever comes first. It is a good idea for the taxpayer to obtain the ATIN in situations where it appears that a Social Security Number will not be issued in time to file tax returns in a timely manner.

To take the adoption credit or exclusion, the taxpayer must complete Form 8839, entitled "Qualified Adoption Expenses," which is used to

itemize qualifying adoption-related expenses. Form 8839 is then attached to either the Form 1040 or Form 1040A, whichever is applicable.

The credit is also reported as a subtraction to taxes owed on the applicable form. Other applicable forms are the Form SS-5, which is used to apply for a Social Security Number for your child, and Form W-7A, mentioned above.

Adoptive parents should make sure to keep all applicable records, receipts, journals, and invoices from their adoption journey and retain this information for at least three years after the credit has been used in full. It is also a good idea for them to either consult a tax professional or their employer's human resources representative to plan for withholdings from their pay in the tax years that the adoption credit is applicable; otherwise, the availability of the funds released to the taxpayer through the tax credit will only be available annually at tax filing time.

While all families may not be able to recoup the entire tax credit in some years, a personal accountant or adoption agency representative can help the family estimate how much they should be able to receive within the allowable time period.

The IRS tax topic can be viewed at <http://www.irs.gov/taxtopics/tc607.html>

The entire IRS publication is available at <http://www.irs.gov/pub/irs-prior/p968--2002.pdf>

Forms referenced in this document can be accessed at:

<http://www.irs.gov/formspubs/index.html?portlet=3>

<http://www.ssa.gov/online/>

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