

Adoption credit and exclusion for qualified adoption expenses

Two tax benefits are available to offset the expenses of adopting a child. For 2007, adoptive parents may be able to claim a credit against their federal tax for up to \$11,390 (\$10,960 for 2006) of "qualified adoption expenses" (see below) for each adopted child. That's a dollar-for-dollar reduction of tax—the equivalent, for someone in the 25% marginal tax bracket, of a deduction of over \$42,000. Also, adoptive parents may be able to exclude from their gross income up to \$11,390 (\$10,960 for 2006) of qualified adoption expenses paid by an employer under an adoption assistance program. The credit is nonrefundable and both the credit and the exclusion are reduced (phased out) if the parents' income exceeds certain limits (see discussion below).

Adoptive parents may claim both a credit and an exclusion for expenses of adopting a child. But they may not claim both a credit and an exclusion for the same expense.

Qualified adoption expenses. To qualify for the credit or the exclusion, the expenses must be "qualified adoption expenses." These are the 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 the legal adoption of an "eligible child" (defined below).

Qualified adoption expenses don't include expenses connected with the adoption of a child of a taxpayer's spouse, expenses of carrying out a surrogate parenting arrangement, expenses that violate state or federal law, or expenses paid using funds received from a federal, state, or local program. Expenses that are reimbursed by an employer don't qualify for the credit, but benefits provided by an employer under an adoption assistance program may qualify for the exclusion.

Expenses in connection with an unsuccessful attempt to adopt an eligible child before successfully finalizing the adoption of another child can qualify. Expenses connected with a foreign adoption (i.e., one in which the child isn't a U.S. citizen or resident) can only qualify if the child is actually adopted.

Taxpayers who adopt a child with special needs will be deemed to have qualified adoption expenses in the tax year in which the adoption becomes final in an amount sufficient to bring their total aggregate expenses for the adoption up to \$11,390 for 2007 (\$10,960 for 2006). They can take the adoption credit or exclude employer-provided adoption assistance up to that amount, whether or not they had \$11,390 (\$10,960 for 2006) of actual expenses.

Eligible child. An "eligible child" is a child under the age of 18 at the time the qualified adoption expense is paid. If the child turned 18 during the year, the child is an eligible child for the part of the year he or she is under age 18. A person who is physically or mentally incapable of caring for himself is also eligible, regardless of age.

Special needs child. This refers to a child who the state has determined cannot or should not be returned to his parents and who can't be reasonably placed with adoptive parents without assistance because of a specific factor or condition, e.g., ethnic background, age, membership in a minority group, medical condition, or handicap. Only a child who is a citizen or resident of the U.S. can qualify as having special needs.

When to claim the credit or take the exclusion. If the qualifying expenses are paid before the year the adoption becomes final, the credit is claimed for the year after the one in which the expenses are paid. If the expenses are paid in the year the adoption becomes final or in a later year, the credit is claimed for the year in which the expenses are paid. For example, say \$3,000 was paid in 2005, \$2,000 in 2006, and \$4,000 in 2007, when the adoption becomes final. The taxpayer claims a \$3,000 credit in 2006 (for the 2005 expenses). The \$2,000 of 2006 expenses and the \$4,000 of 2007 expenses are combined to be claimed in 2007.

Employer-provided adoption benefits are excludable from the employee's gross income for the year in which the employer pays the qualified adoption expense.

In the case of a foreign adoption, neither the credit nor the exclusion may be taken until the year in which the adoption becomes final.

Adoption credit is nonrefundable. The adoption credit is a nonrefundable credit. The amount of the credit can't exceed the sum of your regular and alternative minimum tax, reduced by the sum of your other nonrefundable credits. Thus, while the credit can reduce your tax, it won't cause you to get a refund check.

Phase-out for high-income taxpayers. The credit allowable for any year is phased out for taxpayers with adjusted gross income (AGI) over \$170,820 for 2007 and is eliminated when AGI reaches \$210,820 for 2007. The credit is reduced by a percentage equal to the excess of AGI over \$170,820 divided by \$40,000. For example, say taxpayers who could otherwise claim a \$2,000 credit have an AGI of \$180,820. Their \$180,820 AGI minus \$170,820 equals \$10,000, and \$10,000 divided by \$40,000 is 25%. Accordingly, the taxpayers "lose" 25% of their credit (\$2,000 times 25% is \$500) and can only claim a credit of \$1,500. (Special rules for determining AGI apply in some cases.) The phase-out rules for high-AGI taxpayers apply for the exclusion as well.

The credit allowable for any year is phased out for taxpayers with adjusted gross income (AGI) over \$164,410 for 2006 and is eliminated when AGI reaches \$204,410 for 2006. The credit is reduced by a percentage equal to the excess of AGI over \$164,410 divided by \$40,000. For example, say taxpayers who could otherwise claim a \$2,000 credit have an AGI of \$174,410. Their \$174,410 AGI minus \$164,410 equals \$10,000, and \$10,000 divided by \$40,000 is 25%. Accordingly, the taxpayers "lose" 25% of their credit (\$2,000 times 25% is \$500) and can only claim a credit of \$1,500.

How to claim the credit or take the exclusion for qualified adoption expenses. Adoptive parents who paid qualified adoption expenses or who received employer-provided adoption benefits must use Form 8839 to compute the amount of the credit and the amount of benefits that may be excluded from their gross income.

Child's taxpayer identification number required for credit or exclusion. IRS can disallow the credit and the exclusion if a valid taxpayer identification number (TIN) for the child is not included on the return. Taxpayers can get what is in effect a temporary identification number for a child they are in the process of adopting. This form of TIN, called an adoption taxpayer identification number (ATIN), enables the adoptive parents to claim the credit and exclusion for qualified adoption expenses. Form W-7A is used to get an ATIN. When the adoption becomes final, the adoptive parents must apply for a social security number for the child and, once obtained, the social security number, rather than the ATIN, must be used.

Adopted child may qualify for dependency deduction, other tax benefits. Your legally adopted child will qualify as your dependent if the other dependency tests are met, e.g., you provide more than half of the child's support. Even if the adoption isn't yet final, the child will be your dependent if he or she was placed with you for legal adoption by an authorized placement agency and was a member of your household for at least part of the year. Special requirements apply to adoptions of foreign children who aren't U.S. citizens or residents.

Once a child is your dependent, you will qualify for the dependency deduction and for other tax benefits, such as the child tax credit.