

The New Adoption Tax Credit: More Questions

The adoption expense tax credit was modified and made permanent as part of the tax bill signed by President Bush on June 7, 2001. What will this mean for adoptive families? The answers below are based on past IRS guidance and best conjecture and do not reflect official Treasury Department policy, since the IRS has not yet issued new guidelines.

Q: In a nutshell, what does the new law provide?

A: It provides a tax credit (an amount that can be deducted directly from the taxes you owe) for expenses incurred in the adoption of a child who is not the child of the taxpayer's spouse. All the provisions of the new law are permanent; they will not expire, as the previous tax credit law did. The limitations on the amount of income parents may earn in order to use the credit were increased: now you can take the full amount of the credit if your income does not exceed \$150,000. The amount you can take decreases as your income approaches \$190,000. If you earn above that figure, you don't qualify for the credit.

Details about the credit differ by type of adoption:

- * For the adoption of U.S. children with special needs, the law provides a flat \$10,000 credit, regardless of expenses incurred. The new credit applies to such adoptions finalized after December 31, 2002.
- * For the adoption of U.S. children without special needs, parents can take a tax credit of up to \$10,000 for adoption expenses, even if the adoption is never finalized. This part of the new law takes effect after December 31, 2001.
- * For the adoption of children from other countries, parents can take a tax credit of up to \$10,000 for adoption expenses, but only if and when the adoption is finalized. This also takes effect after December 31, 2001.

Q: How does the IRS define a child with special needs?

A: The child must be a citizen or resident of the U.S. A state must have determined that the child cannot or should not be returned to his parents' home and that the child probably will not be adopted unless some assistance is provided to the adoptive parents. A child who is adopted internationally can never qualify as a child with special needs in this context.

Q: When can the credit be taken?

A: In general, for U.S. special needs adoptions after December 31, 2002, and for intercountry adoptions after December 31, 2001, you take the credit in the year of finalization. For U.S. non-special needs adoptions, the details are complicated but depend on the year the expense was incurred.

Q: What if your tax liability for a particular year is less than your allowable credit for that year?

A: If you reduce your tax bill to zero and still have credit coming to you, the unused credit amount can be carried forward to your next five tax years, or until it is all used, whichever comes first.

Q: Does it make sense to delay final adoption decrees in U.S. special needs and intercountry adoptions until the increased tax credit has gone into effect?

A: Each case would have to be judged individually, but the potential benefit is substantial. If all other factors are neutral, it appears that it would be sensible in these two types of adoptions to wait to finalize in order to take advantage of the increased tax benefit.

Q: Is there any special planning that can be done to maximize benefits with a domestic, non-special needs adoption?

A: Since the date on which the expenses are paid or incurred determines when you can use them for the credit for these adoptions, you could arguably bring expenses under the new law by delaying the date on which they are incurred or paid.

Q: In international adoption, does the IRS consider the overseas adoption or the U.S. readoption to be the final one?

A: It remains to be seen. But I suspect the IRS will rule that, if there is a finalization in the child's country of origin, that date will be used for purposes of the new tax credit. In the case of an adoption that requires finalization to take place in the U.S., then the U.S. date would be used.

From the July/August 2002 issue:

Question: In the case of a domestic adoption finalized after 12/31/01, do expenses incurred before that date qualify for the new \$10,000 tax credit?

Answer: No, they do not. The \$10,000 credit applies only to expenses paid or incurred after 12/31/01. The old law (\$5,000 credit) applies to expenses paid or incurred in a domestic adoption before 1/1/02. The answer is different for an intercountry adoption, in which case expenses paid or incurred before 1/1/02 come under the new law as long as the adoption was finalized after 12/31/01.

Q: In the case of a child who enters the U.S. on an IR3 visa, and an intercountry adoption finalized in the country of origin which is subsequently refinalized in a U.S. state court, which date is considered the date of finalization for purposes of the tax credit: the date of the adoption in the country of origin, or the date of the refinalization?

A: No guidance on this point has been issued by the IRS, but our best guess is that the IRS will use the date of finalization in the country of origin.

Q: Does the tax credit apply per child or per placement—i.e., in the case of a sibling group of two children, is the family entitled to one or two tax credits?

A: The tax credit is per child, not per placement.

Q: In a state that offers reimbursement for special needs adoption expenses, does this reimbursement offset the federal tax credit?

A: No, there is no offset to the federal tax credit for state special needs adoption reimbursements. In fact, after 12/31/02, there will be no need to document expenses in the case of a special needs adoption. Keep in mind that actual expenses in special needs adoptions qualify for the tax credit until 12/31/02, so there is no need to wait until 2003 to claim the credit.

Q: In the case of reimbursement for adoption expenses, must expenses be documented?

A: Yes, adoption expenses must be documented with receipts, except in the case of special needs adoptions finalized after 12/31/02.

Q: If a child enters the US on an IR4 visa—which means his intercountry adoption must be finalized in the U.S.—is this adoption treated as an intercountry adoption (i.e., all expenses are brought forward to the year in which finalization occurs)? Or is it considered a domestic adoption (i.e., qualifying expenses are those incurred in 2001 up to \$5000, and those incurred after 1/1/02 up to \$10,000)?

A: Adoptions from countries of origin requiring a finalization in the U.S. (Korea, for example) are treated as intercountry adoptions. In other words, in such adoptions finalized after 12/31/01, expenses paid or incurred before 1/1/02 will be subject to the law's new \$10,000 limit.