

## **Federal and State Tax Benefits for Adoption Expenses**

*By Jim Bailey*

Adopting a child, either internationally or domestically, is becoming more and more a part of welcoming parents' lives. In addition to the greatness this brings, good news arrives with a bigger tax deduction for such families who have adopted recently.

Recognizing the increase in adoptions, the Federal Government and Massachusetts tax legislation have raised certain benefits for adoption expenses incurred by taxpayers. For federal purposes, taxpayers can claim a tax credit for certain eligible adoption expenses *or* exclude from income employer-provided adoption assistance if the employer maintains an adoption assistance program. The credit and exclusion are subject to a dollar limitation and phase-out for taxpayers whose income exceeds certain thresholds.

For many families wanting to adopt a child the cost that accrues can be a bit overwhelming. To ease the "stress" of the dollar amount and to make adoption more feasible, beginning in 2004, taxpayers can claim a credit for up to \$ 10,390 of qualifying adoption expenses. This limitation applies to the adoption of each eligible child and is cumulative (for that child) over all tax years. The limitation is the same for both married and unmarried taxpayers but married taxpayers must file a joint return to claim the credit. Adoption expenses relating to a child who is a citizen or resident of the U.S. are eligible for the credit, regardless if the adoption is finalized. However, adoption expenses relating to an international adoption or nonresident child do not qualify for the credit if the adoption fails.

An eligible child is any individual who is (a) under the age of 18 at the time of the adoption or (b) physically or mentally incapable of caring for himself or herself. Adoption expenses eligible for the credit include any reasonable and necessary expenses, including adoption fees, court costs, attorney fees, and travel expenses paid in relation to the legal adoption of an eligible child. Expenses incurred for the adoption of a spouse's child or reimbursed under an employer program do not qualify for the credit.

It is extremely important for prospective adoptive parents to maintain adequate detailed records of their adoption related expenses. By keeping track of all expenses, including receipts, cancelled checks, invoices, trip diaries, calendars, documentation of conversations with lawyers and case workers, etc, it will ensure treatment as qualified adoption expenses.

Katie and Paul, new parents this year to a healthy, fun-loving child from the Philippines, recently began compiling the pertinent information they have gathered over the last two years during the adoption process. In addition to the legal expenses, they are able to deduct a portion of other expenses, by saving their airplane receipts, translator receipts, and documented medical invoices. Remember, to save, save, save as it will be another added pleasure at the end of the year.

Claiming the adoption credit is quite simple. All you need to do is complete Part II of Form 8839 and attach it to Form 1040. Be sure to review all forms as there are special timing rules that dictate the appropriate tax year in which to claim the credit and the eligibility to take the credit phases out when a taxpayer's modified adjusted gross income exceeds certain levels. There are also separate rules regarding the adoption of "special needs" children.

It is becoming increasingly more popular for the taxpayer's employer to maintain an adoption assistance program. With this, the taxpayer may exclude from his or her income the adoption expenses paid there under. For 2004, the maximum amount that can be excluded for all tax years for the adoption of a child is \$ 10,390. The allowable exclusion is phased out in the same manner as the adoption credit. Employer paid adoption assistance payments are reported to the employee on Form W-2. The payments are not included in taxable wages, but are shown in box 12 with a code "T".

An individual may claim both a credit and exclusion in connection with the adoption of an eligible child. However, the same adoption expenses cannot be considered for both, and no credit can be claimed for expenses paid by an employer, whether or not paid under an adoption assistance program.

In Massachusetts, the tax law provides for an exemption from tax for qualified adoption expenses. The exemption is for the full amount of the fees paid during the year. In addition, the exemption includes fees paid to an adoption agency on account of the adoption process of a minor child regardless of whether an adoption actually takes place during the taxable year. No exemption is available for any portion of the expenses that are paid or reimbursed by an employer and excluded from gross income under an employer maintained adoption assistance program.

This tax year, remember the benefits of being a parent, as well as the deductions.

Additional information from the Internal Revenue Service (IRS) is available from IRS Publication 968. Good luck!

(Editor's note: Jim Bailey is a principal in the Rockland, MA CPA firm Needel, Welch & Stone, P.C., which works with businesses, individuals and not-for-profits on matters of taxation and business consulting. 1001 Hingham St., Rockland, MA. 781-982-1001.[www.nwscpas.com](http://www.nwscpas.com))