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Tax Benefits for Adoption



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Introduction

This publication explains two new tax benefits available to offset the expenses of adopting a child. These benefits begin in 1997. The first part of the publication is for persons who have recently adopted a child, are in the process of adopting a child, or are considering adopting a child. The second part is for employers who provide adoption assistance payments to workers.

For Adoptive Parents

Beginning in 1997, you may be able to take a new tax credit of up to \$5,000 for qualifying expenses paid to adopt an eligible child. The credit can be as much as \$6,000 if the expenses are for the adoption of a child with special needs. The adoption credit is an amount that you subtract from your tax liability. After 2001, the adoption credit applies only to an adoption of a child with special needs and does not apply to an adoption of a foreign child.

Also, beginning in 1997, through 2001, up to \$5,000 (\$6,000 for a child with special needs) paid or reimbursed by your employer for qualifying adoption expenses under an adoption assistance program may be excludable from your gross income. An adoption assistance program for this purpose is a separate written plan set up by an employer to provide adoption assistance to its employees. See *Adoption assistance program*, later, for more information.

You may claim both a credit and an exclusion for expenses of adopting an eligible child. For example, for an eligible child who is not a child with special needs, you may be able to claim a credit of up to \$5,000 and also exclude up to \$5,000 from your income. However, you cannot claim both a credit and an exclusion for the same expense.

Qualifying Expenses

Qualifying adoption expenses are 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, and whose principal purpose is for, the legal adoption of an eligible child.

Nonqualifying expenses. Qualifying adoption expenses do not include expenses:

- That violate state or federal law,
- For carrying out any surrogate parenting arrangement,
- For the adoption of your spouse's child,
- Paid using funds received from any federal, state, or local program,
- Allowed as a credit or deduction under any other federal income tax rule, or
- Paid or reimbursed by your employer or otherwise (except that amounts paid or reimbursed under an

adoption assistance program may be qualifying expenses for the exclusion).

Eligible child. An eligible child must be:

- 1) Under 18 years old, or
- 2) Physically or mentally incapable of caring for himself or herself.

After 2001, the adoption credit applies only if the eligible child is a child with special needs.

Child with special needs. An eligible child is a child with special needs if he or she is a citizen or resident of the United States (including the District of Columbia and U.S. possessions) and a state determines that the child cannot or should not be returned to his or her parents' home and probably will not be adopted unless adoption assistance is provided to the adoptive parents. A foreign child cannot be treated as a child with special needs. Factors used by states to determine if a child has special needs could include:

- The child's ethnic background,
- The child's age,
- Whether the child is a member of a minority or sibling group, or
- Whether the child has a medical condition or physical, mental, or emotional handicap.

If your state has determined that the child you are adopting is a child with special needs, you should keep evidence of that fact for your records.

Limits on the Credit or Exclusion

The credit and the exclusion for qualifying adoption expenses are each subject to a dollar limit and an income limit. These limits apply separately. The credit is also subject to a limit based on your tax liability. Figure these limits on Form 8839.

How the exclusion limits affect your return. Because of the dollar limit and the income limit, all or part of your employer's adoption assistance payments may not qualify for the adoption exclusion. On your tax return, you must include in your income any payments that do not qualify for the exclusion.

All of the adoption assistance payments will be shown in box 13 of your Form W-2, identified with the letter "T". None of the payments will be included with your taxable wages in box 1 of your Form W-2. Therefore, if all of the payments qualify for the adoption exclusion, you will not need to adjust the amount of wages and other income you report on your tax return. But if any of the payments do not qualify for the exclusion, you must make an adjustment on your return to include in your income the payments that do not qualify. See Form 8839 and its instructions.



Your employer is not required to withhold income tax on payments for qualifying expenses under an adoption assistance program. If you must include any of the payments in your income, your withholding may not be enough to cover the tax on

those payments. Therefore, you may need to give your employer a new Form W-4 to adjust your withholding, or make estimated tax payments, to avoid a penalty for underpayment of estimated tax.

Dollar Limit

The amount of your adoption credit or exclusion is limited to \$5,000 for each effort to adopt an eligible child or \$6,000 for each effort to adopt an eligible child with special needs. If you can take both a credit and an exclusion, this dollar limit applies separately to each. If you and another person adopt a child and both claim the credit or exclusion, this dollar limit applies to your combined credit or exclusion amounts.

The \$5,000 (or \$6,000) amount is the maximum amount of qualifying expenses taken into account over all taxable years. Therefore, it must be reduced by the amount of qualifying expenses taken into account in previous years for the same adoption effort.

Example 1. You are adopting an eligible child who is not a child with special needs. Your qualifying adoption expenses for the credit, before you apply the dollar limit, are \$1,000 for 1998 and \$6,000 for 1999. The maximum amount of expenses you can take into account for the total adoption effort is \$5,000. If you take the \$1,000 into account for 1998, the maximum amount of expenses you can take into account for 1999 must be reduced by the expenses you took into account for 1998. Therefore, your maximum credit for 1999 is \$4,000 (\$5,000 – \$1,000).

Example 2. You adopt two brothers, Bobby and Sam, neither of whom is a child with special needs. Your qualifying adoption expenses for the credit, before you apply the dollar limit, are \$7,500 for Bobby and \$7,500 for Sam. Under the dollar limit, the maximum amount of expenses you can take into account for both adoptions is \$10,000 (\$5,000 for each child).

Example 3. You pay \$3,000 of qualifying adoption expenses in an effort to adopt an eligible child. However, the adoption is not successful. You then pay an additional \$4,000 of qualifying adoption expenses for the successful adoption of a different eligible child. For the dollar limit on the credit, you must treat the \$7,000 of expenses as paid in one adoption effort. The maximum amount of expenses you can take into account is \$5,000 (\$6,000 if the child is a child with special needs).

Income Limit

The income limit on the adoption credit or exclusion is based on **modified adjusted gross income (modified AGI)**. Use the following table to see if the income limit will affect your credit or exclusion.

IF your modified AGI is...	THEN the income limit...
\$75,000 or less	Will <u>not</u> affect your credit or exclusion
\$75,001 to \$114,999	Will reduce your credit or exclusion
\$115,000 or more	Will eliminate your credit or exclusion

Example 1. You are adopting an eligible child who is not a child with special needs. You take into account, after applying the dollar limit, \$1,000 of qualifying expenses for 1998 and \$4,000 for 1999. Your modified AGI for 1998 is \$85,000, and your modified AGI for 1999 is \$95,000. Under the income limit, your credit for both years is reduced ratably. Your 1998 credit is reduced by 25%, to \$750. Your 1999 credit is reduced by 50%, to \$2,000. You cannot take any further credit for this adoption effort.

Example 2. The facts are the same as in Example 1, except that your modified AGI for both years is \$115,000. You cannot take any credit for the adoption expenses.

Modified AGI. To figure your modified AGI for the purpose of the credit and exclusion, add back the following items to your adjusted gross income:

- The foreign earned income exclusion,
- The foreign housing exclusion or deduction, and
- The exclusion for income from Guam, American Samoa, Northern Mariana Islands, or Puerto Rico.

Your modified AGI for purposes of the exclusion also includes the payments from your employer's adoption assistance program.

Tax Liability Limit

The amount of your allowable adoption credit for a year cannot be more than your regular tax liability for that year, minus the following:

- 1) Any credit for child and dependent care expenses,
- 2) Any credit for the elderly or the disabled,
- 3) Any mortgage interest credit, and
- 4) Your tentative minimum tax.

If your credit is more than this limit, you can carry forward the unused credit to your next 5 tax years, or until used, whichever comes first.

When To Take the Credit or Exclusion

When you can take the adoption credit or exclusion depends on whether the eligible child is a citizen or resident of the United States (including U.S. possessions) at the time the adoption effort begins.

Child who is a U.S. citizen or resident. If the eligible child is a U.S. citizen or resident, you can take the adoption credit or exclusion even if the adoption never becomes final. Take the credit or exclusion as shown in the following table.

IF you pay qualifying expenses in...	THEN take the credit in...
• Any year before the year the adoption becomes final	The year <u>after</u> the year of the payment
• The year the adoption becomes final	The year the adoption becomes final
• Any year after the year the adoption becomes final	The year of the payment

IF your employer pays for qualifying expenses under an adoption assistance program in...	THEN take the exclusion in...
• Any year	The year of the payment

Note: You cannot take a credit for any expenses paid before 1997. You cannot take a credit for any expenses paid after 2001, except for expenses to adopt a child with special needs. You cannot take an exclusion for any payment your employer makes after 2001.

Foreign child. If the eligible child is not a U.S. citizen or resident, you cannot take the adoption credit or exclusion unless the adoption becomes final. Take the credit or exclusion as shown in the following table.

IF you pay qualifying expenses in...	THEN take the credit in...
• Any year before the year the adoption becomes final	The year the adoption becomes final
• The year the adoption becomes final	The year the adoption becomes final
• Any year after the year the adoption becomes final	The year of the payment

IF your employer pays for qualifying expenses under an adoption assistance program in...	THEN take the exclusion in...
• Any year before the year the adoption becomes final	The year the adoption becomes final
• The year the adoption becomes final	The year the adoption becomes final
• Any year after the year the adoption becomes final	The year of the payment

Note: You cannot take a credit for any expenses paid before 1997 or after 2001. You cannot take an exclusion for any payment your employer makes after 2001. You cannot take a credit or an exclusion if the adoption becomes final after 2001.

If your employer makes adoption assistance payments in a year before the adoption of a foreign child is final, you must make an adjustment on your tax return for the earlier year to include the payments in your income. Then, on your return for the year the adoption becomes final (provided the adoption becomes final before 2002), you can make an adjustment to take the exclusion. See Form 8839 and its instructions.



Your employer is not required to withhold income tax on payments for qualifying expenses under an adoption assistance program. If you must include the payments in income in the year paid because your adoption of a foreign child is not final, your withholding may not be enough to cover the tax on those payments. You may need to give your employer a new Form W-4 to adjust your withholding, or make estimated tax payments, to avoid a penalty for underpayment of estimated tax.

How To Take the Credit or Exclusion

You must file Form 8839 with either Form 1040 or Form 1040A to take the credit or exclusion. You should maintain records to support any adoption credit or exclusion claimed.

Joint return required. If you are married, you must file a joint return to take the adoption credit or exclusion. However, you can take the credit or exclusion on a separate return if you are legally separated under a decree of divorce or separate maintenance, or if you lived apart from your spouse for the last six months of the tax year and:

- 1) Your home is the eligible child's home for more than half the year, and
- 2) You pay more than half the cost of keeping up your home for the year.

Child's identifying number. You must provide an identifying number for the child on line 1, column (f) of Form 8839. This number is the child's:

- 1) Social security number (SSN) if the child has one or you will be able to obtain one in time to file your tax return. Apply for an SSN on Form SS-5.
- 2) Individual taxpayer identification number (ITIN) if the child is a resident or nonresident alien and not eligible for an SSN. Apply for an ITIN on Form W-7A.
- 3) Adoption taxpayer identification number (ATIN) if you are in the process of adopting a child who is a U.S. citizen or resident and cannot get an SSN for the child until the adoption is final. Apply for an ATIN on Form W-7A.

If you are not sure whether the child is eligible for a social security number, contact your local Social Security Administration office or call 1-800-772-1213. If you need information about Form W-7 or Form W-7A, contact your local IRS office or call 1-800-829-1040.

For Employers

If you have an adoption assistance program, your employees may be able to exclude from gross income payments or reimbursements you make for their expenses to adopt a child. Your employees cannot exclude payments or reimbursements for adoption expenses that were incurred before the adoption assistance program was in effect. For more information on this exclusion, see *For Adoptive Parents*, earlier.

Adoption assistance program. An adoption assistance program is a separate written plan of an employer that meets all of the following requirements.

- 1) It benefits employees who qualify under rules set up by you, which do not favor highly compensated employees or their dependents. To determine whether your plan meets this test, do not consider employees excluded from your plan who are covered by a collective bargaining agreement, if there is evidence that adoption assistance was a subject of good-faith bargaining.
- 2) It does not pay more than 5% of its payments during the year for shareholders or owners (or their spouses or dependents). A shareholder or owner is someone who owns (on any day of the year) more than 5% of the stock or of the capital or profits interest of your business.
- 3) You give reasonable notice of the plan to eligible employees.
- 4) Employees provide reasonable substantiation that payments or reimbursements are for qualifying expenses.

An adoption assistance program can be part of your cafeteria plan. An adoption assistance program also includes programs that reimburse members of the Armed Forces and Coast Guard for adoption expenses.

For more information, see chapter 5 in Publication 535, *Business Expenses*, or Notice 97-9. The notice can be found in *Internal Revenue Cumulative Bulletin 1997-1* and electronically on the Internet.

Employment taxes. For tax years beginning after 1996, amounts you pay or incur under your adoption assistance program for an employee's qualifying adoption expenses are not subject to income tax withholding. However, these amounts are subject to social security, Medicare, and federal unemployment taxes.

Form W-2. You must report all qualifying adoption expenses you paid or reimbursed under your adoption assistance program for each employee for the year in box 13 of the employee's Form W-2. Use Code "T" to identify this amount. Also include this amount in the totals for social security wages in box 3 and Medicare wages in box 5. However, do not include this amount with the employee's wages in box 1.