



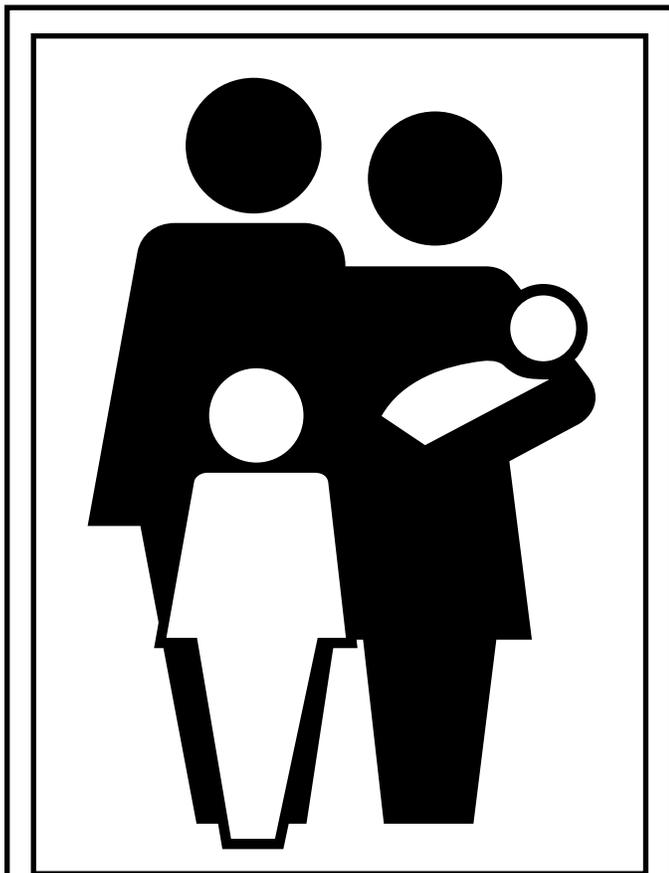
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Tax Benefits for Adoption



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Introduction

This publication explains two tax benefits available to offset the expenses of adopting a child. 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.

Important Changes for 2002

Benefits extended and expanded. There are significant changes increasing the benefits available for adoption. These are discussed later under *New Rules for 2002*.

For Adoptive Parents

You may be able to take a 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.

Also, 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. (However, you cannot exclude this adoption assistance if your employer is an S corporation in which you own more than 2% of the stock or stock with more than 2% of the voting power.) 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* under *For Employers*, 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.

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, *Qualified Adoption Expenses*.

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 12 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 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. Your adoption of an eligible child who is not a child with special needs became final in 2000. You paid \$1,000 in qualifying expenses in 2000. You paid \$6,000 in 2001. When you figure the credit, the maximum amount of expenses you can take into account for the total adoption effort is \$5,000. You take \$1,000 into account for 2000. The maximum amount of expenses you can take into account for 2001 must be reduced by the expenses you took into account for 2000. Therefore, your maximum credit for 2001 is \$4,000 (\$5,000 – \$1,000).

Example 2. In 2001, you adopt two brothers, Bobby and Sam, neither of whom is a child with special needs. Your qualifying adoption expenses are \$7,500 for Bobby and \$7,500 for Sam. When you figure the credit, the maximum total 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 in 2001. However, the adoption is not successful. Later in the year, you 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. Your adoption of an eligible child who is not a child with special needs became final in 2000. You take into account, after applying the dollar limit, \$1,000 of qualifying expenses for 2000 and \$4,000 for 2001. Your modified AGI for 2000 is \$85,000, and your modified AGI for 2001 is \$95,000. Under the income limit, your credit for both years is reduced ratably. You use Form 8839 to find the amount of the reduction. Your 2000 credit is reduced by 25%, to \$750. Your 2001 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.
- 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. When figuring your modified AGI for purposes of the exclusion, you cannot take a deduction for student loan interest.

Tax Liability Limit

The amount of your allowable adoption credit for a year cannot be more than the total of your regular tax (after reduction by any foreign tax credit) and alternative minimum tax (AMT) for that year, minus the following amounts.

- 1) Any credit for child and dependent care expenses.
- 2) Any credit for the elderly or the disabled.
- 3) Any education credits.

4) Any child tax credit.

5) Any mortgage interest credit.

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 tables.

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.

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 tables.

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.

If your employer makes adoption assistance payments in a year before the adoption of a foreign child is final, you must include the payments in your income in the year of payment. Then, on your return for the year the adoption becomes final, 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 are not considered married if you are legally separated under a decree of divorce or separate maintenance. In that case, you can take the credit or exclusion on a separate return.

Married and living apart. You can also take the credit or exclusion on a separate return if all of the following statements are true.

- 1) You lived apart from your spouse for the last six months of the tax year.
- 2) Your home is the eligible child's home for more than half the year.
- 3) 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. Use whichever of the following numbers is appropriate.

- 1) A 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) An 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-7.
- 3) An 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 in time to file your return. 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**.

New Rules for 2002

Beginning in 2002, there are significant changes to the credit and exclusion.

Credit and exclusion extended. The credit, which was scheduled to end after 2001 (except for children with special needs), has been extended. The exclusion, which was also scheduled to end after 2001, has also been extended.

Amount of credit and exclusion increased. In general, the maximum credit and exclusion will increase to \$10,000 beginning in 2002.

Beginning in **2003**, a \$10,000 credit or exclusion will be allowed for the adoption of a child with special needs regardless of whether the taxpayer has qualifying expenses.



At the time this publication was being prepared for print, Congress was considering legislation to make this provision for special needs adoptions effective for 2002.

Income limit. The income limit will also increase. The following table shows whether the income limit will affect the credit or exclusion.

IF your modified AGI is...	THEN the income limit...
\$150,000 or less	will <u>not</u> affect your credit or exclusion.
\$150,001 to \$189,999	will reduce your credit or exclusion.
\$190,000 or more	will eliminate your credit or exclusion.

Expenses paid before 2002. Prior-law dollar limits continue to apply to expenses paid before 2002.

Example. To adopt a child without special needs, you pay \$7,000 of qualified adoption expenses in 2001 and \$3,000 of qualified adoption expenses in 2002. The adoption becomes final in 2002. The maximum amount of expenses you can take into account for this adoption is \$8,000 (\$5,000 from 2001 plus \$3,000 from 2002).

Year credit allowed. The credit for adoption of a child with special needs will be allowed in the year the adoption becomes final, regardless of when any qualifying expenses are paid.



At the time this publication was being prepared for print, Congress was considering legislation to eliminate this provision.

Credit allowed against alternative minimum tax. The provision presently in effect allowing the credit to reduce alternative minimum tax as well as regular income tax has been extended. This provision was originally scheduled to expire in 2002.

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 in-

cludes programs that reimburse members of the Armed Forces and Coast Guard for adoption expenses.

Employment taxes. 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 12 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.

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate at **1-877-777-4778**.
- Call the IRS at **1-800-829-1040**.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1-800-829-4059** if you are a TTY/TDD user.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS*.

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services*. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.



Personal computer. With your personal computer and modem, you can access the IRS on the Internet at **www.irs.gov**. While visiting our web site, you can:

- Find answers to questions you may have.

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- View forms that may be filled in electronically, print the completed form, and then save the form for recordkeeping.
- View Internal Revenue Bulletins published in the last few years.
- Search regulations and the Internal Revenue Code.
- Receive our electronic newsletters on hot tax issues and news.
- Get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at ftp.irs.gov.



TaxFax Service. Using the phone attached to your fax machine, you can receive forms and instructions by calling **703-368-9694**. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

For help with transmission problems, call the FedWorld Help Desk at **703-487-4608**.



Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1-800-829-3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1-800-829-1040**.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1-800-829-4059** to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call **1-800-829-4477** to listen to pre-recorded messages covering various tax topics.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.



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- Popular tax forms that may be filled in electronically, printed out for submission, and saved for record-keeping.
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The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling **1-877-233-6767** or on the Internet at www.irs.gov. The first release is available in mid-December and the final release is available in late January.

IRS Publication 3207, *Small Business Resource Guide*, is an interactive CD-ROM that contains information important to small businesses. It is available in mid-February. You can get a free copy by calling **1-800-829-3676** or visiting the IRS web site at www.irs.gov.