

Adoption Tax Credit Information

What You Need to Know

This is not a substitute for professional financial advice and should not be relied upon without consulting your tax advisor.

If you had adoption-related income and/or expenses, any one or a combination of benefits, credits and exclusions could substantially reduce your tax liability.

NOTE: The tax credit does not cover expenses for adoption of a spouse's child (stepparent adoption).

The Adoption Tax Credit is a valuable benefit for adopting families, but one of the most complicated tax law provisions applicable to middle-income families. The details of how it works, acceptable expenses, who qualifies, and other "small print" items have been harder to understand.

Important Change for 2003

Dollar limit increased. Beginning in 2003, the maximum credit increases to \$10,160. Also, the exclusion from income of benefits under your employer's adoption assistance program increases to \$10,160. You will be allowed these amounts for the adoption of a child with special needs regardless of whether you have qualifying expenses. See *Child with special needs*, for more information.

For Adoptive Parents

You may be able to take a tax credit of up to \$10,160 for qualifying expenses paid to adopt an eligible child. The adoption credit is an amount that you subtract from your tax liability.

Also, up to \$10,160 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.

You may claim both a credit and an exclusion for expenses of adopting an eligible child. For example, you may be able to claim a credit of up to \$10,160 and also exclude up to \$10,160 from your income. However, you cannot claim both a credit and 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:

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

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 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 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.

Caution: 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 \$10,160 for each effort to adopt an eligible child. For this purpose, an attempt that leads to the successful adoption of a child and any unsuccessful attempt to adopt a different child are treated as one effort. If you can take both a credit and an exclusion, the dollar limit applies separately to each. If you and another person adopt a child and both claim the credit or exclusion, the dollar limit applies to your combined credit or exclusion amounts.

The \$10,160 amount is the maximum amount of qualifying expenses taken into account over all tax 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

In 2003, you adopt two brothers, Bobby and Sam. Your qualifying adoption expenses paid in 2003 are \$7,500 for Bobby and \$7,500 for Sam. When you figure the credit, you can take all the expenses into account for both adoptions because they do not exceed the dollar limit of \$20,320 (\$10,160 for each child).

Example 2

You pay \$3,000 of qualifying adoption expenses in an effort to adopt an eligible child in 2003. However, the adoption is not successful. Later in the year, you pay an additional \$9,000 of qualifying adoption expenses for the successful adoption of a different eligible child. Under your employer's adoption assistance program, you are reimbursed for these expenses in 2003. For the dollar limit, you must treat the \$12,000 as paid in one adoption effort. Your exclusion from income is limited to \$10,160. You must include the remaining \$1,840 in your income.

Income Limit

The income limit on the adoption credit or exclusion is based on modified adjusted gross income (modified AGI). For 2003, 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...
\$152,390 or less	will <i>not</i> affect your credit or exclusion.
\$152,391 to \$192,389	will reduce your credit or exclusion.
\$192,390 or more	will eliminate your credit or exclusion.

Example

In 2003, you adopt an eligible child. Your qualifying adoption expenses are \$12,000 and your modified AGI is \$172,390. After you apply the dollar limit (\$10,160), you apply the income limit. You use Form 8839 to figure your credit. The income limit reduces your credit by 50%. Your adoption credit is \$5,080.

Modified Adjusted Gross Income

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.

For purposes of the exclusion, your modified AGI also includes the student loan interest deduction, the tuition and fees deduction, and the payments from your employer's adoption assistance program. Use the worksheet in the Form 8839 instructions to figure your modified AGI for purposes of the exclusion.

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.

- Credit for child and dependent care expenses.
- Credit for the elderly or the disabled.
- Education credits.
- Retirement savings contributions credit.
- Child tax credit.
- 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. Use the worksheet in the Form 8839 instructions to figure your credit carryforward.

Caution: The income limit, discussed earlier, does not apply to a credit carried forward.

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 United States 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 <i>after</i> 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.

Note. For the credit, the amount of expenses paid or incurred before 2002 that can be taken into account is limited to the pre-2002 dollar limits. The limit on these expenses is \$5,000 (\$6,000 in the case of a child with special needs).

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.

Caution: 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.

When adoption is final. When the adoption becomes final depends on the type of immediate relative (IR) visa under which the child enters the United States.

IR-3 visa. The adoption of a child who enters the United States on an IR-3 visa is treated as final in the year the competent authority enters a decree of adoption. The competent authority is the court or other governmental agency of the foreign country that has jurisdiction and authority to make decisions in matters of child welfare, including adoption.

Other IR visas. The adoption of a child who enters the United States on an IR visa other than an IR-3 visa, is treated as final in the year in which a court of the state in which the child and parents reside enters a decree of adoption, re-adoption, or otherwise recognizes the adoption decree of the foreign country.

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.

Married Persons

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.

- 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.
- 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.
- 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**.

Special Rule for Adopting a Child With Special Needs

Beginning in **2003**, the maximum credit and exclusion, subject to the income and tax liability limits discussed earlier, will be allowed for the adoption of a child with special needs even if you do not have any qualifying expenses. For 2003, the maximum amount for each is \$10,160.

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 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. 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.

**South Carolina Reimbursement of Expenses
Related to the Adoption of A Child with Special Needs**

Click on the link below to learn more about the adoption reimbursement program in South Carolina.

[SC adoption reimbursement.pdf](#)