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Individual Tax Update, Part 3

PARTS 1 AND 2 OF THIS ARTICLE ADDRESSED sections of the Job Creation and Worker Assistance Act of 2002 (JCWAA) (P.L. 107-147) pertaining to foster care payments, teacher classroom expenses, and principal residence for a missing child. This month concludes our discussion on personal income tax provisions and the JCWAA by discussing the clarification provisions for adoption expenses.

Background: Between 1997 and 2001, a tax credit or exclusion was provided for qualified adoption expenses paid or incurred by a taxpayer. The maximum credit or exclusion during this period was set at \$5,000 per eligible child (\$6,000 for a special needs child). An eligible child is an individual who has not attained age 18 or is physically or mentally incapable of caring for himself/herself. A special needs child is an eligible child who the state has determined cannot or should not be returned to the home of his/her parents, and the child has a specific factor or condition (such as ethnic background, age, or membership in a minority or sibling group, or the presence of factors such as medical conditions, or physical, mental, or emotional handicaps) whereby it's reasonable to conclude that the child can't be placed with adoptive parents without adoption assistance. In addition, the eligible child must be a citizen or resident of the U.S.

Prior Changes: Act §202(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)

made a few modifications to the adoption expense provisions. First, a taxpayer is able to exclude income received from his or her employer's adoption assistance programs in the year received for adoption expenses or to claim a tax credit for qualified adoption expenses paid or incurred up to \$10,000 per eligible child, including special needs children, beginning in the year 2002. Furthermore, a special provision expands the credit for qualified adoptive expenses for a special needs child after 2002 to be \$10,000, even if the actual expenses were less than

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\$10,000. Second, the AGI phase-out range for the exclusion (or credit) is raised to \$150,000 and \$190,000 (previously, \$75,000 and \$115,000). Finally, the dollar limits and income phase-out threshold amounts are inflation adjusted beginning in the year 2003. Unfortunately, there were a number of unanswered questions resulting from this legislation.

Revised Legislation: In the JCWAA, the credit (not the exclusion) is taken in the taxable year following the taxable year that the expenses are paid or incurred unless the adoption is finalized. Where the adoption is (or has been) finalized, the expenses are allowed as a credit in the year they are paid or incurred. The unresolved question is which dollar limits applied for those amounts paid or incurred during taxable year 2001 if the adoption isn't finalized until at least the following year since the maximum limit increased to \$10,000 beginning in 2002.

Act §411(c)(1)(F) of JCWAA resolves this by providing

that expenses paid or incurred during any taxable year beginning before January 1, 2002, may be taken into account in determining the credit under IRC §23 only to the extent the total of such expenses doesn't exceed the applicable limitation under IRC §23(b)(1), which is in effect on the day before the date of the enactment of the EGTRRA. Put succinctly, expenses paid or incurred prior to January 1, 2002, are subject to the \$5,000 (or \$6,000) dollar cap even though they can't be claimed as a credit until 2002.

The second clarification appears in Act §411(c)(1)(C), which removes the provision added by EGTRRA limiting the credit in the case of a special needs adoption to the year that the adoption becomes final. Thus, adoption expenses incurred in years prior to the adoption becoming final are excluded from income in the year following the expenditure (not the year incurred). In addition, new paragraph (3) is inserted in IRC §23(a) and states that in the case of an adoption of a child with special needs that becomes final during a taxable year, the taxpayer shall be treated as having paid qualified adoption expenses during such year with respect to such adoption in an amount equal to the excess (if any) of \$10,000 over the aggregate qualified adoption expenses actually paid or incurred by the taxpayer with respect to such adoption during such taxable year and all prior taxable years. This provision is effective beginning in 2003.

Finally, Act §418(a)(1) of JCWAA provides a uniform rounding rule (to the nearest multiple of \$10) that applies to the inflation-adjusted dollar and income limitations beginning

in 2002. This revision is effective as if it were included in the provision of EGTRRA to which it relates, thus making it similar to other inflation-adjustment provisions.

To appreciate these clarifications, look at the following two examples.

Example 1: Jamie and Rob adopt Sara. They incur adoption expenses of \$7,000 in year 2001 and \$4,000 in year 2002. The adoption doesn't become final until year 2002. As a result, the couple can claim a tax credit for adoption expenses of \$9,000 in year 2002.

Example 1 Reasoning: Since Sara isn't a special needs child, the limit for claiming adoption expenses in year 2001 is \$5,000. Because the adoption wasn't finalized in 2001, therefore, the couple can claim only \$5,000 of the \$7,000 incurred. The unclaimed \$2,000 (\$7,000-\$5,000) from year 2001 is lost and can't be claimed in year 2002 because there is no carryover provision. In 2002, the limit for claiming adoption expenses is \$4,000, which is the lower of actual cost incurred or \$5,000 (\$10,000—claims of prior years). As a result, the couple can claim the \$4,000 in year 2002.

Example 2: Gary is a special needs child who is adopted by Ronda and Dumont. The couple incurs adoption expenses of \$1,000 in year 2001, \$3,000 in year 2002, and \$5,000 in year 2003. The adoption is finalized in 2003. Since Gary is a special needs child, the couple can claim a tax credit for adoption expenses of \$10,000 as follows:

- \$1,000 in year 2002 from the \$1,000 incurred in year 2001,
- \$3,000 in year 2003 from the

- \$2,000 incurred in year 2002,
- \$5,000 in year 2003 from the \$5,000 incurred in year 2003, and
- \$1,000 in year 2003, which is the excess of \$10,000 over the total adoption expenses incurred.

Example 2 Reasoning: In this case, the limit for claiming a tax credit for adoption expenses incurred in 2001 is \$1,000 (lower of actual cost incurred or \$5,000), and it's claimed in year 2002. The limit for claiming a tax credit for adoption expenses incurred in year 2002 is \$3,000 (lower of actual cost incurred or \$9,000 (\$10,000—claims of prior years)), which is claimed in year 2003. Since the adoption is finalized in 2003, the couple can claim a tax credit for adoption expenses up to \$5,000 (lower of actual cost incurred or \$6,000 (\$10,000—claims of prior years)) and an additional \$1,000 (excess of \$10,000 over \$9,000 (all prior claims)).

One final issue should be noted here. If the adoption of a special needs child is not finalized, for whatever reason, any excess adoption expenses cannot be claimed by the couple. In Example 2, the couple would not be able to claim the additional \$1,000 in year 2003, or any time thereafter, if the adoption was never finalized. ■

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