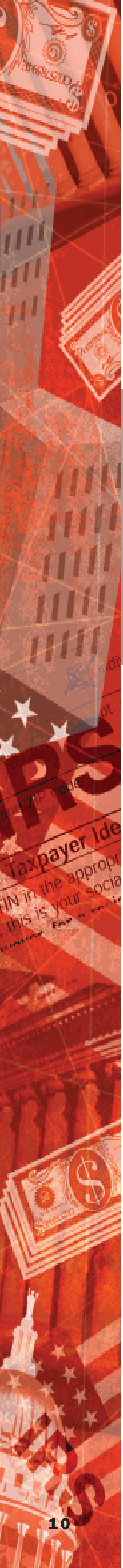
By Robert H. Lee and Anthony P. Curatola



The Adoption Credit

With the IRS often taking a close look at taxpayers who claim the adoption credit, special care should be taken when preparing their returns to ensure that the provisions are followed appropriately. This includes the eligibility of the child, qualified expenses, and the application procedure.

The average adoption process carried an approximate price tag of $30,000 in 2009-2010, according to *Adoptive Families* magazine. For many of these adoption families, some financial relief was made available through their employer's adoption assistance program. For others, some tax relief was provided by an adoption exclusion and/or tax credit. The Patient Protection and Affordable Care Act (P.L. 111-148, March 23, 2010) made things better for some taxpayers by allowing them to take advantage of both the exclusion and tax credit provisions for the same adoption. And still better, the adoption credit was made a refundable credit for 2010 and 2011, which makes it currently the largest refundable tax credit available to taxpayers.

But similar to other tax credits, properly claiming and receiving the tax break can be a challenging task. In 2011, the U.S. Government Accountability Office (GAO) reported that a correspondence audit was requested by the IRS for approximately 60% of the tax returns claiming the adoption credit. The major issues being looked at were the eligibility of the child, the qualified adoption expenses, and the application procedure. The good news is that the IRS only assessed additional tax on about 17% of the 35,000 tax returns on which an audit was completed. As a result, taxpayers and tax preparers should be on notice to do their due diligence in satisfying the requirements of these provisions when claiming the adoption credit.

Child Eligibility

Under IRC §36C(d)(2), an eligible child is any child under the age of 18 or physically or mentally unable to take care of himself or herself. A child of special needs is one that meets all of the following conditions: (1) the child is a U.S. citizen or resident, (2) the state determines the child can't or shouldn't be returned to his or her parent's home, and (3) the state determines that the child probably won't be adopted unless assistance is provided. Pursuant to IRC §36C(d)(1)(C), a child from a taxpayer's spouse doesn't qualify as an eligible child. In addition, a child that celebrates his or her 18th birthday on January 1 is considered to be 18 on January 1 (Rev. Rul. 2003-72, 2003-2 CB 346), contrary to other tax provisions that hold a person attains an age on the day prior to his/her birthday.

Qualified Adoption Expenses

Qualified adoption expenses include adoption fees that are reasonable and necessary where the principal purpose is for the adoption of the child. Examples of such qualifying expenses include court costs, travel expenses, and attorney fees (IRC §36C(d)(1)). Items that aren't considered qualifying expenses for claiming the tax credit

ILLUSTRATION: ANN BOYAJIAN/ARTVILLE

include any funds paid or reimbursed from an employer or organization and any funds received from another credit or tax benefit under the federal income tax law, such as funds from a state or local federal program. The general rule of thumb is that a cost will qualify if (1) it occurred for the principal purpose of legally adopting a qualified child, and (2) it hasn't been reimbursed to the taxpayer.

Conditions for Claiming the Adoption Exclusion and Tax Credit

For 2010 and 2011, the maximum adoption exclusion and tax credit amounts that a taxpayer can claim are $13,170 and $13,360, respectively. The exclusion and tax credit phase out, however, if an individual's modified adjusted gross income (MAGI) exceeds $185,210 (2011) or $182,520 (2010), and they completely phase out once MAGI reaches $225,210 (2011) or $222,520 (2010). In the case of the tax credit, taxpayers can claim it in the year the adoption is final. If the child is a U.S. citizen/resident and the taxpayer incurs qualified expenses prior to the finalization of the adoption, the taxpayer may take the credit in the year after the payment (not in the year of payment or necessarily the year the adoption is finalized). If the child isn't a U.S. citizen/resident, however, the tax credit is taken only in the year the adoption is final. Finally, if the expenses occurred after the adoption is finalized, then the credit can be taken the year of the payment regardless of whether the child is or isn't a U.S. citizen/resident.

A special rule applies for those taxpayers adopting a special-needs child. That is, the maximum adoption credit may be taken regardless of the costs incurred by the taxpayer. On the surface, this has the potential to provide addition relief to these taxpayers. But since the cost of adopting is likely to exceed the tax credit amount, the provision is more symbolic than beneficial. Taxpayers may also exclude up to $13,360 of employer-provided adoption assistance. A key variable is once again whether the child is a U.S. citizen/resident or foreign. If the child is a U.S. citizen/resident and an employer pays for the qualifying expenses under an adoption assistance program, the taxpayer can then exclude that amount from his or her income on the year of the payment. This includes years before the adoption is final. But if the child isn't a U.S. citizen/resident and the employer's support is received before the adoption is final, the taxpayer must wait for the year when the adoption is finalized to exclude the qualified amounts from income.

A special bonus is available for adoptions in 2010 and 2011. In these years, taxpayers are allowed to claim both the exclusion on qualified amounts received and the credit for qualified adoption expenses. But be aware that taxpayers aren't allowed to claim the exclusion and tax credit for the same expense (i.e., no double-dipping). This means a taxpayer may be able to exclude $13,360 from income and receive a $13,360 tax credit simultaneously if there are enough adoption expenses and his or her employer has an adoption program. For example, a taxpayer paid $22,000 in qualified adoption expenses for the year and the adoption is finalized. The taxpayer's employer provides an adoption assistance program and reimbursed the taxpayer $10,000 toward the adoption expenses. The taxpayer may exclude $10,000 from income and also receive a $12,000 adoption credit. If the taxpayer's employer didn't have an adoption assistance program, then the employee could only claim a tax credit of $13,360 toward the qualified adoption expenses of $22,000.

In 2010 and 2011, taxpayers are allowed to claim both the exclusion and the credit.

Nuances of the Adoption Credit Application

Taxpayers qualifying for the adoption credit must include the required documentation along with the filing of Form 8839, *Qualified Adoption Expenses*, with their federal tax return. The tax return can't be e-filed; it must be filed in paper form. In the case of a married couple, they must file jointly to claim the credit or exclusion—with one exception: A married couple may file separately if they are considered unmarried and meet all of the following conditions: (1) they lived apart from each other during the last six months of the year, (2) the eligible child lived in the taxpayer's home more than half of the year, and (3) the taxpayer provided over half the cost of keeping his or her home (See Instructions of Form 8839).

Expediting the Process

The key way to minimize a delay when claiming the adoption credit is to include the appropriate documents with a submitted tax return. According to the GAO, the first screening process is to make sure the taxpayer's documents are complete and valid. Examples of documents are a final adoption decree, home study by an authorized placement agency, and the state's determination if the child has special needs. Valid documents include statements signed from the hospital, court orders, and notarized statements from the adoption attorney. A detailed list can be found at: www.irs.gov/individuals/article/0,,id=252106,00.html.

Using the Credit

It isn't too late for taxpayers who completed an adoption in either 2010 or 2011 to claim the credit—they need to file an amended tax return. For those taxpayers looking to adopt now or in the near future, the adoption credit is available but isn't as attractive. The credit amount returns up to $12,650, is nonrefundable, and a taxpayer will be eligible to claim either the exclusion or credit but not both. Of course, the 2011 adoption provision could be extended. It's an election year, and provisions have been extended commonly and routinely. **SF**

Robert H. Lee is an assistant professor of accounting at Pepperdine University and can be contacted at Robert.Lee2@pepperdine.edu or (610) 717-2327.

Anthony P. Curatola is the Joseph F. Ford Professor of Accounting at Drexel University in Philadelphia, Pa., and a member of IMA's Greater Philadelphia Chapter. You can reach Tony at (215) 895-1453 or curatola@drexel.edu.