

The impact of adoption on personal income tax



FAMILY TAX ISSUES

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As a parent of two adopted children and as a certified public accountant, I am often asked about the tax issues connected with adoption. In many instances, the adopted child will be a couple's first child, and it is very likely that they have never thought about how their tax situation may change now that they are parents.

While a full discussion of the tax issues is beyond the scope of this column,

there are a few things adoptive parents and their planners should consider.

Dependency exemption

Most parents are aware of the fact that an exemption can be claimed for a child, assuming that the child meets the Internal Revenue Service's criteria as a "qualifying child." The issue for parents who adopt is, at what point does the adopted child meet the definition of a "child"?

The law is clear here in that the child will meet the definition of a child when the adoption is finalized and he or she has been legally adopted by the taxpayers — or when the child is legally placed with the taxpayer for legal adoption.

This distinction can become important — especially in situations where the child is legally placed with the taxpayers near the end of the year, but the adoption will not become finalized until after the start of the new calendar year. To clarify, in this situation, the taxpayers would be able to claim the child as a dependent when the child is placed with them. For 2007, the dependency exemption will be \$3,400.

Social Security number

In order to claim a child as a dependent, the child must have a valid Social Security number. Your client can obtain a Social

Security number by completing IRS Form SS-5 and providing the required documentation to the Social Security Administration. (The form and instructions are available on the IRS's Web site, www.irs.gov.)

In some situations, the information necessary to obtain a valid Social Security number may not yet be available to the parents in time to get the number for inclusion in their tax return. In cases like these, the parents can get a temporary adoption identification number by completing IRS Form W7-A, "Application for Taxpayer Identification Number for Pending U.S. Adoptions" (also available on the IRS Web site). This temporary identification number can be used until a valid Social Security number is assigned.

Child tax credit

A tax credit of \$1,000 is available for every eligible child the parents have who is under the age of 17. Generally, if the child qualifies as a dependent (see above) and meets the age requirement, he or she will qualify for the parents to take the credit.

The credit is a dollar-for-dollar offset against the parents' tax (and therefore is much more valuable than a deduction, which reduces a parent's or couple's income). The child tax credit is phased out in certain situations depending on the parents' income. In addition to the child tax credit, there is a refundable additional child tax credit for certain individuals who get less than the full child tax credit.

Further, beginning in 2006, New York state enacted a child tax credit of its own equal to 33 percent of the federal credit. Parents should be aware that the New York child tax credit, or Empire State child credit, will only be available to them if the child is four years of age or older.

Adoption credit

Perhaps the largest single tax benefit available to parents who adopt is the credit for qualified adoption expenses. Surprisingly, though, many couples who adopt are

completely unaware of the credit.

The adoption credit is claimed by filing IRS Form 8839, "Qualified Adoption Expenses," with the taxpayer's return for the year in which the adoption becomes final. For 2006, the maximum credit available was \$10,960 but, since it is adjusted for inflation, it is likely to increase for future years. This credit is limited depending on the taxpayer's income, and the benefit starts to phase out for couples with modified adjusted gross income in excess of roughly \$164,000.

In order to claim the credit, taxpayers must keep track of all of their qualifying expenses. Which expenses will qualify is broadly defined and, for example, includes legal expenses connected with the adoption, agency fees, court costs, necessary travel and readoption expenses relating to the adoption of a foreign child. Often, expenses in connection with an adoption are incurred in a year prior to or subsequent to the year in which the adoption became final. In this case, there are special rules as to when the expenses can be considered eligible for the credit.

The taxpayers can claim a credit for their eligible expenses up to \$10,960. Amounts spent in excess of this limit cannot be claimed in a subsequent year, however. In cases where the adopted child is determined to be a child with "special needs," the adopting parents can claim a credit for the full \$10,960, even if their qualifying expenses were much less. There are specific rules about when a child is considered as having special needs, so the parents should consult with their adoption attorney and tax adviser.

There are also special rules that pertain to the finalization of an adoption and how any employer-provided adoption benefit may impact the amount of credit. The taxpayers will certainly want to discuss these special rules with their tax adviser.

More often than not, the adoption credit will completely eliminate the parents' tax for the year. If this occurs, the unused por-

tion of the credit can be carried forward for five years.

In some instances, it may be beneficial for the parents to reduce their federal withholding for the subsequent year. Normally, this would lead to a larger balance due when they file their return the following April, but, since they have the credit carryforward available, this problem would be mitigated. In effect, they get to enjoy the benefit of the credit during the year instead of seeing the benefit in April when they file their return.

Child and dependent care credit

If the parents pay expenses to someone to watch their child while they work, those expenses may qualify for the child and dependent care credit. Depending on the parents' income and the amount of qualifying expenses incurred, the credit may be as high as \$1,050 per qualifying child.

The credit can be claimed by completing and attaching Form 2441, "Child and Dependent Care Expenses," to their return. New York state offers a similar but smaller credit to taxpayers who qualify for the federal credit.

Estate planning

While it would be difficult to persuade a client to think about estate planning while they are celebrating their adoption, it is an important consideration. For the first time, they will need to consider who they will choose as guardian for their child in case of their passing. It also allows them to document any special bequests to a child or make provisions for a child with special needs.

Adopting a child is one of the most exciting events in a person's life. It is comforting to know that the government clearly supports adoption — as well as having children in general — and provides a number of benefits to parents along the way.

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