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Tax Benefits for Adoption

For use in preparing

2002 Returns



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Important Changes for 2002

Beginning in 2002, there are significant changes to the tax benefits for adopting a child.

Credit and exclusion extended. The exclusion and the part of the credit that were scheduled to end have been extended.

Dollar limit increased. In general, the maximum credit and exclusion increases from \$5,000 (\$6,000 in the case of a child with special needs) to \$10,000.

Expenses paid before 2002. The amount of expenses paid or incurred before 2002 that can be taken into account is limited to the pre-2002 dollar limits. This is true even if an adoption became final in 2002, or has not yet become final.

Income limit increased. The credit or exclusion is reduced if your modified adjusted gross income (AGI) is more than \$150,000 (previously \$75,000). No credit or exclusion is allowed if your modified AGI is more than \$190,000 (previously \$115,000).

Important Change for 2003

Dollar limit increased. Beginning in 2003, the maximum credit or exclusion increases to \$10,160. This amount will be allowed for the adoption of a child with special needs regardless of whether the taxpayer has qualifying expenses. See *Child with special needs*, for more information.

Introduction

This publication explains two tax benefits available to offset the expenses of adopting a child. The benefits are the adoption credit and the exclusion from income of benefits under your employer's adoption assistance program.

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.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

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For Adoptive Parents

You may be able to take a tax credit of up to \$10,000 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 \$10,000 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, you may be able to claim a credit of up to \$10,000 and also exclude up to \$10,000 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.

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.



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 \$10,000 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 \$10,000 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.



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, defined later).

Example 1. You adopt a child with special needs in 2002. You paid \$7,000 of qualified adoption expenses in 2001 and \$3,000 of qualified adoption expenses in 2002.

The maximum amount of expenses you can take into account for this adoption is \$9,000 (\$6,000 from 2001 plus \$3,000 from 2002).

Example 2. In 2002, you adopt two brothers, Bobby and Sam. Your qualifying adoption expenses paid in 2002 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 \$20,000 (\$10,000 for each child).

Example 3. You pay \$3,000 of qualifying adoption expenses in an effort to adopt an eligible child in 2002. 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 2002. For the dollar limit, you must treat the \$12,000 as paid in one adoption effort. Your exclusion from income is limited to \$10,000. You must include the remaining \$2,000 in your income.

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...
\$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.

Example. In 2002 you adopt an eligible child. Your qualifying adoption expenses are \$12,000 and your modified AGI is \$170,000. After you apply the dollar limit (\$10,000), 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 \$5,000.

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.

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.

- 1) Credit for child and dependent care expenses.
- 2) Credit for the elderly or the disabled.
- 3) Education credits.
- 4) Retirement savings contributions credit.
- 5) Child tax credit.
- 6) 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.

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.

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.

- 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**.

Special Rule for Adopting a Child With Special Needs

Beginning in **2003**, a \$10,160 credit or exclusion will be allowed for the adoption of a child with special needs regardless of whether you have qualifying expenses.

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.

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 includes 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, 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.



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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**.
- *Solving problems.* Take advantage of Everyday Tax Solutions service by calling your local IRS office to set up an in-person appointment at your convenience. Check your local directory assistance or **www.irs.gov** for the numbers.
- *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 use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.



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- *Services.* You can walk in to your local IRS office to ask tax questions or get help with a tax problem. Now you can set up an appointment by calling your local IRS office number and, at the prompt, leaving a message requesting Everyday Tax Solutions help. A

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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 **http://www.irs.gov/cdorders**. The first release is available in early January and the final release is available in late February.



CD-ROM for small businesses. IRS Publication 3207, *Small Business Resource Guide*, is a must for every small business owner or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions and publications needed to successfully manage a business. In addition, the CD provides an abundance of other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer.

It is available in March. You can get a free copy by calling **1-800-829-3676** or by visiting the website at **www.irs.gov/smallbiz**.