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Federal Adoption Tax Credit for Special Needs Adoptions

Beginning in tax year 2003, families adopting a child with special needs from foster care were allowed access to this same tax credit without needing to document expenses. For tax year 2005, the tax credit is \$10,630 per child and you have this year and up to the next five years in which to use it. For families that adopted in 2002 or earlier, you can only claim the credit against expenses you paid related to the adoption process.

- **The first question many people ask, or are asked by their tax preparer is, "How do I know if my child is considered to have special needs according to the IRS?"**

The North American Council on Adoptable Children interprets the Instruction to say: if you receive an adoption subsidy (assistance) for your child, that means the state that provides the subsidy has determined your child has special needs. Your adoption subsidy agreement (or application and agreement) is the evidence that the state has determined your child to have special needs. **Note:** this information used to be contained in IRS Publication 968, which is now obsolete. That same information is now contained in the Instructions for Form 8839.

Instructions for Form 8839, which can be found at <http://www.irs.gov/instructions/i8839/ch02.html#d0e285>, is quoted below:

Column (d)

A child is a child with special needs if all three of the following apply.

- 1. The child was a citizen or resident of the United States or its possessions at the time the adoption process began.*
- 2. A state (including the District of Columbia) has determined that the child cannot or should not be returned to his or her parents' home.*
- 3. The state has determined that the child will not be adopted unless assistance is provided to adoptive parents. Factors used by states to make this determination include:*
 - a. The child's ethnic background and age,*
 - b. Whether the child is a member of a minority or sibling group, and*
 - c. Whether the child has a medical condition or physical, mental, or emotional handicap.*

If you check the box in column (d), be sure to keep evidence of the state's determination in your records.

- **The second most common question is, "What does this mean to our family?" We don't know the specific answer to that question because we don't do your taxes. However, we can help you figure it out.**

Many people believe the Federal Adoption Tax Credit won't help them because they get a refund every year, but that isn't necessarily true. A refund means you have overpaid what you owe in federal income tax, so the IRS refunds you the amount overpaid. The tax credit is applied against what you owe, and could reduce it to \$0, which would increase your refund. The amount that you owe is the

(over)

number you come up with from the tax tables (the number in line 28 of the 1040A, or line 46 of the 1040). Here are some examples of how the tax credit might benefit your family.

- Family one is a couple who adopts a sibling group of two children with special needs. They typically have \$6,500 in federal income tax withheld from their paychecks, and the tax that they owe is \$7,000, which means they owe \$500 in April. Now, with the adoption tax credit, they have \$21,260 in credits, and this year they could use up to \$7,000 of the credit.¹ This will mean they get a refund this year of \$6,500, and will have at least \$14,260 of tax credit to carryover for up to four years.
- Family two is a single mother who adopts a sibling group of three children with special needs. Typically she has \$5,000 in federal income tax withheld from her paychecks, and the tax that she owes is \$4,000, which means she receives a refund of \$1,000 in April. Now, with the adoption tax credit, she has \$31,890 in credits, and this year she could use up to \$4,000 of the credit.¹ This will mean she will get a refund this year of \$5,000, and will have at least \$27,890 of tax credit to carryover for up to four years.
- Family three is a couple with five children who adopts a sibling group of two children with special needs. They typically have \$1000 in federal income tax withheld from their paychecks, and the tax that they owe is \$0, which means they receive a refund of \$1,000 in April. Now, with the adoption tax credit, they have \$21,260, but with no tax liability they are unable to use any of the adoption tax credit this year. They can still claim the tax credit, but it has to be in the year that the adoption was finalized. The credit would carryforward for the next five years or until it is used up. The two most likely reasons a family would claim it is if their tax liability varies greatly from year to year, or if the children already in their household are near adulthood and may no longer be claimed as dependents (or take the child tax credit) in the next five years.

Information for filling out Form 8839: Qualified Adoption Expenses

If you do your own taxes, you may have a couple questions when you fill out Form 8839.

• What do you do when they ask for qualifying expenses on line 5 and you didn't have any?

Go to page 4 of the Instructions for Form 8839, which can be found at <http://www.irs.gov/instructions/i8839/ch02.html#d0e640>, quoted below, it says:

But, if you adopted a child with special needs and the adoption became final in 2005, enter \$10,630 on line 5.

This means that you do NOT have to document qualifying expenses to take the credit.

• What if the tax you owe is less than \$10,630?

Then you will also need to fill out the Credit Carryforward Worksheet on page 4 of the Instructions for Form 8839. This is how you are able to carry the remaining credit forward for up to the next five years or until it is used up.

Finally, if you receive adoption subsidy (assistance) for your child and have questions on whether it is taxable income or if you can claim that child as a dependent, you should read our fact sheet, which can be found at <http://www.nacac.org/subsidyfactsheets/taxes.html>.

If you have questions on the adoption tax credit, contact the North American Council on Adoptable Children at 651-644-3036 or adoption.assistance@nacac.org.

¹ If you can claim the child tax credit (see IRS publication 972) or other credits, you should claim them.