Steven M. Vogt, CPA, EA

Birth or Adoption of a Child

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- Education Savings Plans
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- Medical Expenses
- Adoption Credit

Tax Exemption – A taxpayer who files a federal tax return and is not someone else's dependent is allowed an exemption for themselves, their spouse, and each of their dependents. An exemption reduces a taxpayer's taxable income for the year, and the inflation adjusted exemption amount for 2015 is $4,000 (up from $3,950 in 2014). What an exemption means to a specific taxpayer in terms of tax savings depends upon the individual's tax bracket. Most taxpayers are in the 15% and 25% brackets. Thus, for example, a taxpayer in the 25% tax bracket would save $1,000 $4,000 x 25%) in federal taxes because of the additional exemption. For higher-income taxpayers and those affected by the alternative minimum tax (AMT), the exemption amount may be reduced or not allowed at all.

Children are generally dependents of their parent(s), and the new parent(s) will be able to claim an additional $4,000 (2015) personal exemption for the newborn or adopted child. The full amount of the exemption is allowed regardless of when during the year the child was born (see special rules for adopted children below). In other words, the parent(s) will receive the full exemption (not prorated for the year) whether the child was born on January 1st of the year or December 31st. You may recall those media stories every January 1st about the first child born in your local hospital for the New Year. Although the new parent(s) got all the attention for having the first born in the New Year, they also lost a $4,000 (2015) tax deduction that they would have had if the child had been born on December 31st. The exemption cannot be split between two taxpayers, so if the new parents are unwed, the dependency–and 100% of the tax deduction for the exemption–will generally go to the child's custodial parent.

Adopted Children – An adopted child is always treated as the taxpayer's own child. An adopted child includes a child lawfully placed with the taxpayer for legal adoption. Generally, a taxpayer is allowed an exemption for an adopted child, provided the child is both younger than the adoptive parent and is under the age of 19 or a full-time student under the age of 24. There are special rules for foreign adopted children; please call for additional information.

Filing Status – If you are married and have been filing a Joint return, the birth or adoption of a child will not change your filing status. But if you are unmarried and have been filing your tax returns using the Single status, the addition of a child to your household may allow you to use the Head of Household filing status. Eligible Head of Household filers are allowed increased tax benefits. For example, the 2015 federal standard deduction, which is claimed in lieu of itemizing deductions, is $9,250 (up from $9,100 in 2014) for Head of Household vs. $6,300 (up from $6,200 in 2014) for Single status. Many phase-outs of various deductions and credits have higher-income thresholds for Head of Household filers than Single filers, which could result in the Head of Household filer claiming a bigger deduction or credit than a Single filer with the same income. Additionally, the ranges of income are wider for most federal tax rates for Heads of Households than for Singles. For example, a taxpayer with $50,200 of taxable income in 2015 would still be in the 15% tax bracket if filing as Head of Household, but would be in the 25%

bracket if filing Single. Thus, the Head of Household filer would pay less tax.

Generally, an unmarried taxpayer can claim the Head of Household status if the taxpayer is a U.S. citizen or resident and pays more than half of the cost of maintaining as his or her home a household which is the main home for more than half the year of a qualifying child, or for a child born during the year, the period during which the child lived in the home. The Head of Household status may also apply when a home is maintained for other qualifying relatives or when certain married individuals who are considered unmarried maintain a household for an eligible child. Please call for details.

Child Tax Credit – Taxpayers are allowed a tax credit of $1,000 for each qualifying child. A qualifying child is one that is under the age of 17 at the end of the year, is not self-supporting, who lived with the taxpayer over half the year and is a U.S. Citizen or national. Children who were born during the year are treated as living with the taxpayer for over half the year even if born in the last half of the year. This credit is generally nonrefundable except for certain low-income taxpayers. Nonrefundable means it can be used to reduce your income tax to zero, but any additional credit is lost. Thus, a qualifying taxpayer with a tax liability of $900 and a child credit of $1,000 would be able to reduce their tax liability to zero, but the $100 excess credit would be lost. The allowable credit does offset the alternative minimum tax (AMT) and the credit is phased out for higher-income taxpayers. The income phase-out threshold for married taxpayers is $110,000, $75,000 for unmarried taxpayers and $55,000 for married taxpayers filing separately.

Adopted child - An adopted child is always treated as the taxpayer's own child. An adopted child includes a child lawfully placed with the taxpayer for legal adoption. In the case of foreign adoptions, if the taxpayer is a U.S. citizen or U.S. national and the adopted child lived with the taxpayer all of the tax year as a member of the taxpayer's household, that child is treated as being a U.S. citizen, national or resident.

Medical Expenses – The birth of a child is usually accompanied by medical expenses for the care of the mother and the newborn child. Those expenses not reimbursed by insurance or other reimbursement arrangements are added to the taxpayer's other medical expenses for the year, and deducted as an itemized medical expense to the extent the medical expenses exceed 10% (7½% for taxpayer age 65 and older through 2016) of his or her adjusted gross income (AGI).

Where couples are unable to conceive by natural means, some of the artificial methods that have been developed are deductible and some are not. Although not specifically addressed in the tax code or regulations, in vitro fertilization performed on the taxpayer claiming the expense is deductible since the tax code specifically allows procedures that affect the structure or function of the body. IRS has ruled privately that a woman who can't conceive children using her own eggs may claim a medical expense deduction for the costs of obtaining an egg donor, including associated legal costs. The office of IRS Chief Council provided some guidance related to surrogate mother expenses: The tax code allows a taxpayer to deduct the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents. A surrogate mother is neither the taxpayer nor the taxpayer's spouse, and typically is not a dependent of the taxpayer. Nor is an unborn child a dependent. Thus, medical expenses paid for a surrogate mother and her unborn child would not qualify as a deduction.

Please call this office for more information related to deductible childbirth expenses and future medical expenses of the children.

Education Savings Plans – Along with the newborn or adopted child is the future obligation to educate the child. It is never too soon to start thinking about saving for future educational expenses. The tax code provides two tax-favored plans to save for a child's education. One is called a Coverdell Education Savings Account and the other is the Sec. 529 Plan (also referred to as a Qualified State Tuition Plan). Neither plan provides for a current tax deduction, but both provide for tax-free earnings when the funds are used for the prescribed education expenses. The three major differences in the plans are the amounts that can be contributed, which education is covered, and who has control of the funds. Contributions to the Coverdell account are limited to $2,000 per year per future student, whereas the contributions to a Sec. 529 plan are only limited by the projected cost of the future education. Coverdell qualified education includes kindergarten through post-secondary education, while Sec. 529 qualified education only includes college (post-secondary) education. Control of the Coverdell Account reverts to the child when the child reaches maturity, while the Sec. 529 plan remains under the control of the contributor. There are other important details relating to each plan, and a consultation appointment is recommended before embarking on a plan.

Child Care Credit – For working parents, the birth or adoption of a child can lead to the need for child care when the parent resumes their employment. A nonrefundable tax credit may be available for the expenses that are incurred for the care of a child (who generally must be under 13 years of age), disabled child, spouse, or other dependent while the taxpayer is gainfully employed (or is job seeking). In addition, employer dependent care assistance programs allow employees to exclude from income certain payments expended for child and dependent care.

Generally, the credit is 20% of the cost of the care with a maximum expense limit of $3,000 for one child and $6,000 for two or more. However, for lower-income taxpayers, the credit percentage can be as high as 35%.

The expenses that are taken into account for the credit are limited to a taxpayer's earned income (i.e. income from working), and must be reduced by the amount a taxpayer excludes from gross income under an employer-provided dependent care assistance plan. Generally, self-employed taxpayers use the net earnings on Schedule C as earned income.

For taxpayers who file joint returns, the expense is limited to the earned income of the lower paid spouse, so generally both parents must be working or looking for work. Special rules allow a spouse who is disabled or a full-time student to qualify as having earnings when they otherwise have none, thus permitting the couple to claim some credit.

Earned Income Credit - The Earned Income Tax Credit (EIC) provides a refundable tax credit for people who work, but have lower incomes. The taxpayer (or spouse if married filing jointly) must be age 25 through age 64. The credit amount is increased if a family also has children. Qualifying taxpayers may receive a refund even if they have had no income tax withheld. Each year, the credit and income limits are adjusted for inflation. If a taxpayer qualifies, this credit could be worth up to $6,242 for 2015 (up from $6,143 in 2014) for a taxpayer with 3 qualifying children. Thus, a qualifying taxpayer will pay less federal tax or could even get a larger refund. While taxpayers without children may qualify for the EIC, the potential amount of the credit is significantly more for eligible taxpayers who have one or more qualifying children. These taxpayers are also allowed to earn over 2½ times more income before the credit is phased out than workers without qualifying children.

The IRS estimates 20 to 25% percent of people who qualify for the credit do not claim it.

Adoption Credit - Adoptive parents may be able to claim a dollar-for-dollar tax credit for the "qualified" expenses of adopting a child – up to $13,400 for 2015 (up from $13,190 in 2014) for each adopted child. That is equivalent to a deduction of over $53,600 for a taxpayer in the 25% tax bracket. This credit is a nonrefundable credit that may not exceed the sum of a taxpayer's regular and alternative minimum taxes, but any unused credit can be carried forward up to 5 years.

In addition, if the employer has an adoption assistance program, a taxpayer may be able to exclude up to $13,400 for 2015 (up from $13,190 in 2014) of qualified adoption expenses paid by an employer from his or her gross income. Both the credit and the exclusion can be claimed but not for the same expenses.

The credit is phased out if the taxpayer's income (modified AGI) exceeds a threshold amount and is fully eliminated when AGI reaches the threshold cap. These values are annually adjusted for inflation, and for 2015, the threshold income is $201,010 (up from $ 197,880 in 2014) and the threshold cap is $241, 000 (up from $237,880 in 2014).

Qualified adoption expenses include 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 the legal adoption of an "eligible child." However, the expenses do not include those to adopt a spouse's child, surrogate mother expenses, and adoption arrangements that are in violation of state or federal laws. Expenses in connection with an unsuccessful attempt to adopt an eligible child before successfully finalizing the adoption of another child can qualify. Expenses connected with a foreign adoption can only qualify if the child is actually adopted.

An "eligible child" is a child under the age of 18 at the time the qualified adoption expense is paid. If the child turned 18 during the year, the child is an eligible child for the part of the year he or she is under age 18. A person who is physically or mentally incapable of caring for him- or herself is also eligible, regardless of age.

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