THE TAX EXCLUSION FOR ADOPTING CHILDREN WITH SPECIAL NEEDS

By Sheldon R. Smith

Sheldon R. Smith is a professor of accounting at the Utah Valley State College School of Business in Orem, Utah and an adoptive parent.

In this article, he discusses the evolution of the exclusion for employer adoption assistance payments for adoptions of children with special needs. He shows how some ambiguities in the law were partially clarified but how confusion still exists. He gives suggestions for further clarification of the law. Smith would like to thank Lynn R. Smith, Sarah D. Smith, and Glade K. Tew for their valuable comments.

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I. Introduction

The exclusion for employer adoption assistance payments was first enacted as IRC section 137 by the Small Business Job Protection Act of 1996.1 The section originally allowed a $6,000 exclusion from gross income for amounts paid by an employer for qualified adoption expenses of an employee in the case of an adoption of a child with special needs. The exclusion for adoptions of other children was limited to $5,000. The exclusion was scheduled to expire after December 31, 2001, but was extended through 2010 and expanded to $10,000 by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).2 In an earlier article, I described the major changes to the exclusion (and the related credit) and discussed some ambiguities created by these changes.3 I also explained that many of those ambiguities were clarified by additional changes through the Job Creation and Worker Assistance Act of 2002.4

In fact, although many of those ambiguities were clarified, there is still possible confusion in the tax law related to the exclusion for adoptions of children with special needs. This article discusses the evolution of section 137 over time, showing how the exclusion has changed and how it is still confusing. Possible ways to further clarify the exclusion in the specific case of the adoption of children with special needs are suggested.

II. Special Needs Exclusion

Other than the definition of a child with special needs, the definitions and limitations provided in section 137 apply to exclusions for all adoptions.5 However, this

1P.L. 104-188.
2P.L. 107-16.
4P.L. 107-147.
5For adoptions of foreign children, the timing rules for the exclusion are different from those for domestic adoptions. For
taxpayer.... ' 'Also included in that definition are some
for, the legal adoption of an eligible child by the
directly related to, and the principal purpose of which is
court costs, attorney fees, and other expenses which are
directly related to, and the principal purpose of which is
a dollar limita-

"An eligible child is a child with special needs
special needs must first be an eligible child for purposes
of the adoption exclusion.10

Two limitations apply to the exclusion for adoptions of
children with special needs. The first is a dollar limi-
tion. For 2005 the exclusion is limited to $10,630 per
adoption. The second is an income limitation. A $40,000
modified adjusted gross income (MAGI) phaseout range
exists such that, for 2005, the exclusion will start to be
reduced when MAGI reaches $159,450.11 The exclusion
will be completely phased out for those whose MAGI
reaches $199,450.12

III. Special Needs Exclusion Preference
The exclusion for adoptions of children with special
needs has some advantages over the exclusion for other
adoptions. The specific advantages will be discussed in
the next section as the evolution of this specific exclusion
is described. This section will discuss some of the reasons
for giving a better exclusion for special needs adoptions.
In addition, some historical tax return data from 1997 and
1998 will be reviewed to give some information about
special needs adoptions.

A. Reasons for a Better Special Needs Exclusion
Many possible reasons exist for providing preferential
tax benefits for adoptions of children with special needs.
By definition, the adoption of a child with special needs
may not be likely without some adoption assistance. Tax
benefits are one way of providing adoption assistance.
Other government programs also exist to help families
that adopt children with special needs.13

In many cases, children with special needs are sup-
ported by government-sponsored foster care programs.
Thus, it may be beneficial from a government cost
standpoint to enable the adoption process in those cases,
not only to provide permanent, loving homes for these
children, but also to reduce foster care costs.

Many adoptive parents of children with special needs
may have related expenses that are not qualified adop-
tion expenses. Those costs may not be for the legal
adoption of a child but may be a result of the legal
adoption of such a child. Some examples of additional
costs that might result from adopting a child with special
needs include (1) costs to make a home accessible for
the child, (2) costs to retrofit a car/van for transportation use,
(3) costs for special schooling needs, (4) costs for addi-
tional, specialized healthcare, (5) costs for additional
ongoing care and/or supervision, and (6) costs for extra
security for a child with emotional or physical problems
or for someone who may harm himself or herself or
others in some way. In many cases, those costs related to

10For purposes of the exclusion, AGI is modified by adding
back any foreign earned income exclusion, any foreign housing
exclusion or deduction, any exclusion of income earned by
residents of American Samoa or Puerto Rico, any student loan
interest deduction, and any tuition and fees deduction. In
addition, MAGI includes any benefits received from an employ-
er’s adoption assistance program. See section 137 and Publica-
tion 968.


12See 42 USC sections 673 and 637b for information on the
federal government adoption assistance program and the grants
made to states in support of adoptions of children with special
needs.

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adoptions of children with special needs may be ongoing and may continue for a long time, even a lifetime, after the legal adoption is finalized.

B. Historical Data on Special Needs Adoptions

The Small Business Job Protection Act of 1996 directed the secretary of the Treasury Department to submit a report to Congress about the effect of the adoption tax credit and exclusion on adoptions. The report, dated October 2000, included some statistics on adoption tax benefits claimed for the 1997 and 1998 tax years.\(^\text{14}\)

The report suggests that there were about 31,000 adoptions of children with special needs in each of the years 1997 and 1998. Of those, only about 4,700, or 15 percent, resulted in adoption tax benefits in 1998. One reason why so few of the adoptions of children with special needs resulted in tax benefits is that “the costs of adopting children with special needs are eligible for reimbursement through government expenditure programs, and, in many cases, these reimbursements appear to fully cover the costs of the adoptions.”\(^\text{15}\)

Between 1997 and 2001, the exclusion from gross income for employer-paid adoption costs for the adoption of a child with special needs was potentially $6,000 (and the related tax credit was potentially another $6,000). However, taxpayers would make no claim for either the exclusion or the credit if they incurred no qualified adoption expenses due to government payment of the adoption costs.

IV. Evolution of Special Needs Exclusion

Tax breaks for adoption began in the early 1980s. This section reviews the evolution of those tax breaks, including the current special needs exclusion.


The Economic Recovery Tax Act of 1981\(^\text{16}\) introduced a tax deduction of up to $1,500 for qualified adoption expenses that were directly related to the adoption of children with special needs. Those children were also able to get support for ongoing care, but not adoption expenses, from the government. The Tax Reform Act of 1986\(^\text{17}\) repealed the deduction but provided for some direct government assistance for adoption expenses for families that adopted children with special needs.\(^\text{18}\) The current adoption tax benefits, both the exclusion and the credit, were first legislated in 1996.

B. Small Business Job Protection Act of 1996

The Small Business Job Protection Act of 1996\(^\text{19}\) included a credit for adoption expenses paid by the adoptive taxpayers and an exclusion from gross income for adoption costs paid by an employer for an employee. For payments to qualify for the exclusion, the employer had to have a written adoption assistance program. The maximum exclusion for an adoption of a child with special needs was $6,000, whereas other adoptions had an exclusion limit of $5,000. The MAGI phaseout range for losing the exclusion benefit was $75,000 to $115,000. The exclusion was not available for any adoption costs incurred before 1997.

The original wording of the exclusion in section 137(a) was:

(a) IN GENERAL. — Gross income of an employee does not include amounts paid or expenses incurred by the employer for qualified adoption expenses in connection with the adoption of a child by an employee if such amounts are furnished pursuant to an adoption assistance program.\(^\text{19}\)

The dollar limitation was listed in section 137(b):

(b) LIMITATIONS. —

(1) DOLLAR LIMITATION. — The aggregate amount excludable from gross income under subsection (a) for all taxable years with respect to the adoption of a child by the taxpayer shall not exceed $5,000 ($6,000, in the case of a child with special needs).\(^\text{20}\)

The exclusion was scheduled to expire at the end of 2001. Therefore, additional legislation was needed to renew the adoption tax benefits.

C. EGTRRA of 2001

EGTRRA not only renewed the adoption tax benefits, it also expanded them. Under EGTRRA, the exclusion for all adoptions, including those of children with special needs, increased to a maximum of $10,000. EGTRRA made several other changes to the adoption tax benefit legislation. The expiration dates on the adoption tax benefits were eliminated, although the provisions of EGTRRA sunset after 2010; thus, the tax benefits are not yet permanent.\(^\text{21}\) The MAGI phaseout range shifted upward so the lower bound on the range was $150,000. In addition, the $10,000 exclusion limit and the lower bound on the $40,000 phaseout range were both indexed by EGTRRA so they would increase each year starting in 2003.\(^\text{22}\)

Perhaps the most significant change to the exclusion for adoptions of children with special needs was the provision that made the exclusion available regardless of adoption expenses. Thus, even with no adoption expenses, an employee could potentially exclude $10,000.


\(^{15}\)Id. at 2.

\(^{16}\)P.L. 97-34.

\(^{17}\)P.L. 99-513.

\(^{18}\)Treasury report, supra note 14.

\(^{19}\)P.L. 104-188, supra note 1.

\(^{20}\)Id.

\(^{21}\)Legislation has been proposed to eliminate the EGTRRA sunset provision for adoption benefits. H.R. 1057, which would have eliminated the sunset provision, was passed, 414-0, by the House in September 2004. However, that bill was not acted on by the Senate. Already in 2005, bills have been introduced in the House (H.R. 268, H.R. 305, and H.R. 347) and Senate (S. 246), all of which would eliminate the EGTRRA sunset provision for adoption tax benefits.

\(^{22}\)See Smith, supra note 3, for a discussion of the major changes EGTRRA made to the adoption tax benefits.
from gross income (2002 amount) for the adoption of a child with special needs. EGTRRA amended section 137(a) to read as follows:

(a) IN GENERAL. — Gross income of an employee does not include amounts paid or expenses incurred by the employer for an employee if such amounts are furnished pursuant to an adoption assistance program. The amount of the exclusion shall be —

(1) in the case of an adoption of a child other than a child with special needs, the amount of the qualified adoption expenses paid or incurred by the taxpayer, and

(2) in the case of an adoption of a child with special needs, $10,000.23

By 2005, the indexing on that amount has increased it to $10,630. Although the dollar limit for the exclusion is the same for all adoptions, the exclusion for the adoption of a child with special needs has the additional preference of being available regardless of expenses.

Smith points out some ambiguities from the 2001 legislation relating to the special needs exclusion. “The wording left the exclusion for an adoption of a child with special needs unclear.”24 The lack of clarity came because the paragraph still spoke of an employer paying for adoption expenses of an employee under an adoption assistance program, but for an adoption of a child with special needs, it was unclear whether the employer could simply pay the employee $10,000, regardless of expenses, or if the employer had to pay for adoption expenses but without the requirement that they be qualified adoption expenses. In addition, it was unclear, since the wording of the exclusion for a special needs adoption was no longer related to qualified adoption expenses, that stepparent adoptions and surrogate parenting arrangements would not be eligible for the exclusion. Also, the timing of the special needs exclusion was unclear, both for any actual expenses incurred and for amounts not expended but which were eligible for the exclusion.

Another point that became unclear was the reference to the adoption of an eligible child. The definition of qualified adoption expenses is the only place where the requirement exists that the adoption be an adoption of an eligible child. Without linking the exclusion for adoptions of children with special needs to the definition of qualified adoption expenses, it became less clear whether a child with special needs had to first meet the definition of an eligible child.

D. Job Creation and Worker Assistance Act of 2002

The changes to section 137 by the Job Creation and Worker Assistance Act of 2002 were billed as “technical corrections.” After amendment for those corrections, section 137(a) reads as follows:

(a) EXCLUSION. —

(1) IN GENERAL. — Gross income of an employee does not include amounts paid or

23P.L. 107-16, supra note 2.
24Smith, supra note 3, at 1067.

expenses incurred by the employer for qualified adoption expenses in connection with the adoption of a child by an employee if such amounts are furnished pursuant to an adoption assistance program.

(2) $10,000 EXCLUSION FOR ADOPTION OF CHILD WITH SPECIAL NEEDS REGARDLESS OF EXPENSES. — In the case of an adoption of a child with special needs which becomes final during a taxable year, the qualified adoption expenses with respect to such adoption for such year shall be increased by an amount equal to the excess (if any) of $10,000 over the actual aggregate qualified adoption expenses with respect to such adoption during such taxable year and all prior taxable years.25

Those corrections clarified almost all of the ambiguities created by EGTRRA.26 The amended wording does seem to clarify the timing of both the exclusion for any actual expenses and the exclusion available even when expenses are less than the maximum possible exclusion. The wording also reintroduces the term “qualified adoption expenses” in relation to adoptions of children with special needs. However, further analysis shows that much potential confusion still exists because of the wording of section 137.

V. Confusion From the Special Needs Exclusion

A. Section 137(a)

As amended by the Job Creation and Worker Assistance Act of 2002, section 137(a) is still confusing. One way to interpret the subsection is with paragraph (1) treated as a general rule and paragraph (2) as an exception to the general rule. Although paragraph (2) does not specifically state it is an exception, it might be read that way, especially if each paragraph on the same level should stand on its own except by specific reference to other paragraphs. The heading for paragraph (2) may also give the impression it is an exception. However, if this interpretation is correct, the text of paragraph (2) does not actually define any exclusion, let alone a $10,000 exclusion regardless of expenses. It simply describes how QAE in the case of an adoption of a child with special needs are increased by any amount up to the maximum exclusion in the year of finalization if not already used as actual QAE in the current and prior years for this adoption. This paragraph defines the timing of the “deemed” QAE,27 but it does not describe how or when that amount can be excluded from gross income. Under this first interpretation, if the argument is made that the

25P.L. 107-147, supra note 4.
26Smith, supra note 3.
27The term “deemed,” although not used in section 137, does seem descriptive in this case. Expenses are deemed to have been incurred even though they were not. This term was borrowed from a list of frequently asked questions (with answers) about adoption assistance plans at http://www.mwe.com/info/adoption/faq.html.
exclusion for deemed expenses is implied by the self-contained heading and text of paragraph (2), the employer would not necessarily have to pay the deemed expenses nor would the employer have to have an adoption assistance program.

A second way to interpret subsection (a) is to treat paragraph (1) as a general rule with paragraph (2) as an addition to the general rule in the specific case of the adoption of a child with special needs. That interpretation can be made by looking back to paragraph (1) for the determination that the deemed QAE introduced in paragraph (2) can be excluded. That seems like a logical extension since the QAE referred to in paragraph (2) are not stated as eligible for the exclusion unless they are tied back to the QAE in paragraph (1). Under that interpretation, it makes sense that other requirements of paragraph (1) would also apply to paragraph (2) — the employer would have to make payment and an adoption assistance program would have to exist.

Those two interpretations are obviously different, as one implies the existence of an employer adoption assistance program and employer payment while the other does not. The intention of the legislation cannot be simultaneously met by both of them.

B. Definitions

Section 23 on the adoption tax credit defines qualified adoption expenses, eligible child, and child with special needs. Section 137 incorporates a modified definition of qualified adoption expenses by reference to section 23.28 However, section 137 does not define eligible child or child with special needs, either directly within the section or by reference to section 23. Those omitted definitions could cause confusion to someone reading section 137.

Because section 23 defines qualified adoption expenses in terms of “expenses . . . related to . . . the legal adoption of an eligible child” and then defines eligible child separately, perhaps it can be argued that the definition of qualified adoption expense incorporated in section 137 by reference implies the definition of eligible child found in section 23 as well. However, it would be better to clearly state the definition in section 137 or reference the definition found in section 23, especially for those who are not looking at section 23 specifically. Also, no definition of child with special needs is found either directly or indirectly in section 137.

C. Linking of Qualified Adoption Expenses

Smith discussed the problem in the EGTRRA wording that separated the issue of QAE from the exclusion for special needs adoptions.29 The problem arose because it is the definition of QAE itself that prohibits the adoption tax benefits from applying to stepparent adoptions or surrogate parenting arrangements. When the exclusion was no longer linked to QAE, the prohibition would not technically apply. Although the Job Creation and Worker Assistance Act of 2002 reintroduced the term QAE in the paragraph about the exclusion for adoptions of children with special needs, it did not necessarily link the definition of QAE back to the exclusion. Deemed expenses are QAE, not because they necessarily meet the definition of QAE as enacted. Of course, when ambiguities in the law exist, the IRS may have to interpret the law, perhaps by looking for congressional intent. By looking at Form 8839 and the Instructions for Form 8839 (for 2004), it seems clear that the IRS interpretation of the exclusion for adoptions of children with special needs indicates a need for an adoption assistance program but that no employer payment for deemed QAE need exist. That interpretation actually seems to be a split between the two interpretations described above. While the IRS may know more about the intent of the legislation than is available in the legislation itself and may have therefore interpreted the law by intent rather than specific wording, it seems like this split interpretation cannot easily be read into the actual wording of section 137(a).

The Instructions for Form 8839 (for 2004) are quite explicit that an employer adoption assistance program needs to be in place for the exclusion to apply to deemed expenses. However, someone who does not read the instructions and goes straight to Form 8839, Part III, could easily fill out the form and take an exclusion for deemed expenses even without an employer that had an adoption assistance program or even without an employer.

E. Unusual Results Possible

When actual QAE occur and are reimbursed or paid by the employer, the exclusion is straightforward and easy to understand. The amount paid by the employer for the adoption expenses is excluded from the employee’s gross income if other qualifications are met and if the limitations are not exceeded.31 However, what happens in the case of deemed expenses? Under the IRS

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28Section 23 explicitly states that QAE for the credit would not include amounts reimbursed by an employer. The modification in section 137 is that QAE for the exclusion would include employer payments.

29Smith, supra note 3.

30Of course, this extreme position could only be taken if there were no actual QAE for that particular adoption, because any actual QAE would already imply that the adoption could not be a stepparent adoption.

31Excludable amounts are not subject to income taxes, but they are still subject to Social Security and Medicare taxes.
interpretation, deemed expenses do not have to be paid by the employer to qualify for the exclusion. Therefore, the exclusion for deemed expenses means that other income is reduced. That is accomplished by reducing the amount that would otherwise be listed on line 7 (Wages, salaries, tips, etc.) of Form 1040. Thus, instead of being the exclusion of a specific reimbursement or payment that would otherwise be classified as income, it is the exclusion of income from a general category.

Suppose Stan and Barbara Johnson adopt a sibling group of four children, ages 2, 4, 7, and 10. Because of the circumstances, the children qualify as children with special needs. The adoptions become final in 2005, and the Johnsons incur no expenses for the adoptions. Stan’s income as a public school teacher is $35,000, and the school district he works for has an adoption assistance plan that will reimburse employees up to $2,000 of their actual adoption expenses for each adoption. Barbara stays home to care for the children.

Because Stan’s employer has an adoption assistance program, the exclusion applies even though no expenses were incurred by the Johnsons. Under the IRS interpretation that no employer reimbursement needs to take place for deemed expenses to qualify for the exclusion, the Johnsons will decrease line 7 on Form 1040 for the entire exclusion amount related to four adoptions, $42,520 ($10,630 x 4). Since the Johnsons’ exclusion from gross income is more than the salary Stan earns, theoretically the total on Form 1040, line 7 could be 0 if not a negative $7,520.32

Another possible unusual result of the exclusion for deemed expenses is that the exclusion may not be subject to Social Security and Medicare taxes. Normally, actual adoption expense amounts paid by the employer which are excludable are still subject to those other taxes. If the exclusion for deemed expenses is used only to offset Form 1040, line 7 income which is subject to Social Security and Medicare taxes, the excluded amount is still subject to those taxes. However, if line 7 ends up as a negative amount and other income is offset, that other income may not be subject to Social Security and Medicare taxes, thus implying that part of the excluded amount might not actually be subject to those taxes.

F. Cafeteria Plan Spending Account

Section 125 allows some otherwise excludable items to provide an employee tax benefit through a flexible spending arrangement operated within a cafeteria plan. An employer can allow an employee to have his or her salary reduced on a pretax basis through an election, with the reduction amount going into an account to pay for certain expenses on behalf of the employee. Examples of qualified benefits include healthcare costs, dependent care expenses, and adoption expenses. Because flexible spending arrangements are for a specific plan year, a use-it-or-lose-it rule applies for amounts contributed to a plan but not used for that plan year.33 Since the flexible spending account contributions are a reduction of the employee’s salary, the benefit for the adoption exclusion operated in this manner is not as great for the employee as it is when the employer makes direct payments. However, the benefit to the employee is that those payments can be made in a way to avoid income taxes on the amounts paid.

Smith and Tew discuss the use of flexible spending accounts for adoption expenses: “Since the timing and amount of adoption expenses are more uncertain than medical and child care costs in most cases, trying to plan in advance for an amount to put into an adoption spending account can be very risky. . . .”34 For regular adoptions, the use of a flexible spending account for adoption expenses, although risky for timing and amount, is straightforward on a conceptual basis. The employee will make an election to have a certain amount subtracted from his/her salary before taxes. The amount would be put into a flexible spending account during the coming plan year for adoption expenses. When qualified adoption expenses are incurred, they can be reimbursed from the account, providing a pretax payment of adoption expenses.

Conceptually, the same process would take place for actual QAE related to the adoption of a child with special needs. What would happen to the deemed QAE? It seems as if the IRS interprets the “regardless of expenses” phrase to also imply “regardless of employer payment.” If an employer does not have to pay deemed QAE in order for them to qualify for the exclusion, it seems reasonable that an employee’s flexible spending account would also not have to pay deemed QAE for them to be excludable. Any deemed expenses could qualify for the exclusion on Form 8839 even though they did not flow through a flexible spending account. Suppose an employer had no direct reimbursement program but did allow employees to create flexible spending accounts for adoption costs. What would happen in the case of a special needs adoption with no actual QAE flowing through a flexible spending account? Would the employee need to make an election for a flexible spending account even though nothing was contributed/reimbursed, or would no election be required?

33The use-it-or-lose-it rule, in essence, prohibits the salary reduction from becoming deferred compensation by being used for a future year, even if used for a qualified item. However, Notice 2005-42 allows employers to modify their cafeteria plans so that amounts in a flexible spending account can be used for eligible expenses up to 2 months and 15 days past the end of the plan year and still be eligible for reimbursement from amounts contributed to the account in that plan year. That makes the election and use of flexible spending arrangements even more flexible.
In contrast, what about a case in which an employee put  $3,000 of actual QAE and $7,630 of deemed QAE with the actual amount they spent. Thus, they would have adoption expenses'' equal to the excess of $10,630 over 'treated as having paid during such year [2005] qualified that amount. 

The actual QAE totaled $5,000, and Stephanie's employer had special needs and finalized the adoption in 2005. The circumstance might result in confusion as to what expenses qualify for the credit and what expenses qualify for the exclusion. 

Suppose Ken and Stephanie Peters adopt a child with special needs and finalize the adoption in 2005. The actual QAE totaled $5,000, and Stephanie's employer had an adoption assistance program which pays $2,000 of that amount. For the credit, Ken and Stephanie are "treated as having paid during such year [2005] qualified adoption expenses'' equal to the excess of $10,630 over the actual amount they spent. Thus, they would have $3,000 of actual QAE and $7,630 of deemed QAE with respect to the credit. With reference to the exclusion, section 137(a)(2) says, "the qualified adoption expenses with respect to such adoption for such year [2005] shall be increased by an amount equal to the excess (if any) of $10,630 [as indexed] over the actual aggregate qualified adoption expenses with respect to such adoption during such taxable year and all prior taxable years." 

From the wording alone, it seems unclear that the defined increase in QAE is only referring to the exclusion. Also, it seems unclear whether the actual aggregate QAE that need to be subtracted would be the $2,000 paid by the employer or the $5,000 paid by both the Peters and the employer. Of course, if the Peters qualify for both the full exclusion and the full credit regardless of expenses, the deemed expenses eligible for the exclusion would need to be $8,630 [$10,630 - $2,000], not $5,630 [$10,630 - $5,000]. A change in the wording might make it clear that both the full exclusion and the full credit are available for an adoption of a child with special needs regardless of expenses. 

Although it is unlikely employers will pay deemed QAE, the benefit to employees is much greater if they do. Thus, the wording should be clear so as to allow the exclusion for deemed QAE, whether the employers pay them or not.

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VI. Suggestions to Improve Section 137

The wording of section 137 should be improved, either so the current IRS interpretation is reflected in the wording of the tax code or so the intentions of the tax code are made clear so the IRS can interpret and administer them appropriately. Some wording changes are suggested in this section.

A. Definitions

The definitions of eligible child and child with special needs should be incorporated into section 137, either directly or by reference to the definitions given in section 23. That would be a simple technical correction but would greatly clarify the meaning of terms used in section 137. Although sections 23 and 137 both contain adoption tax benefits, each section should be interpretable as a separate document, even if some of the interpretation comes from referencing other tax code sections.

Assuming a child with special needs must first be an eligible child for purposes of the adoption tax benefits, this should be more explicitly stated in the definition of a child with special needs. For example, section 23(d)(3) could be reworded to state, ‘The term ‘child with special needs’ means any eligible child if . . . ’ That way the paragraph defining the exclusion for adoptions of children with special needs would not need to rely on the assumption that deemed QAE would be for an eligible child; instead it would be implicitly stated because a child with special needs would already have to be an eligible child. Again, that same change should be included in section 137, either directly or by reference.

Parts of the definition of qualified adoption expense, found in section 23(d)(4) and incorporated by reference (with modification) in section 137(d), should be removed from that definition and put elsewhere in those sections. The parts referring to violation of law, surrogate parent arrangements, and stepparent adoptions should be stated elsewhere so taxpayers with deemed QAE could not claim that those parts of the law do not apply to them because they do not have any actual QAE.

B. Clarify Special Needs Exclusion

Section 137(a) needs to be clarified so the connection between paragraphs (1) and (2) is unambiguous. If paragraph (2) is to be an exception to the general rule, that should be stated explicitly, but then the text of the paragraph should explicitly provide for an exclusion for the deemed expenses. In addition, if the requirement that an adoption assistance program be in place was intended by legislators, it should be added to paragraph (2) since that paragraph would not be tied to paragraph (1).

Alternatively, if paragraph (2) is to be an addition to the general rule, that concept should be worded more explicitly. However, paragraph (2) would then need to specifically state that deemed expenses do not need to be paid by the employer if that is the intent of the law. With either of those adjustments, the relationship between those paragraphs would be clarified and the intention of the exclusion for deemed expenses would be unambiguous.

C. Deemed Expenses for Credit and Exclusion

Sections 23 and 137 need to be coordinated so that when each section allows a tax benefit for deemed

35Publication 968, supra note 10, at 2.
expenses for adoptions of children with special needs, it is clear that the total of actual QAE and deemed QAE will be large enough to qualify for both the full exclusion and the full credit. In section 23, the deemed expenses are “treated as having been paid” by the taxpayer in the year the adoption of a child with special needs becomes final. Perhaps section 137(a)(2) could have wording that would increase QAE by an amount equal to the excess of the maximum possible exclusion over the actual aggregate qualified adoption expenses paid by the employer in the current and previous tax years. The paragraph could further state that any of that excess not actually paid by the employer would be assumed paid by the employer. This wording would explicitly allow the employer to pay deemed QAE. If the deemed QAE defined that way were either paid or assumed paid by the employer, those deemed expenses would qualify only for the exclusion, and the deemed expenses treated as having been paid by the taxpayer in the year of finalization would qualify only for the credit.

D. Other Related Changes
Once the adoption tax benefit laws are clarified and made consistent with intention, Form 8839 or the instructions for Form 8839 may need to be adjusted. For example, if the current instructions for Form 8839 are written according to intention, it would be helpful to modify Form 8839 slightly so taxpayers could not inadvertently take the exclusion for deemed expenses if they had no employer with an adoption assistance program. IRS guidance should be published that would clarify any requirements for flexible spending arrangements for deemed expenses. Although that information would not be necessary in the tax code itself, it should be given in appropriate IRS publications so any ambiguities are clarified.

In addition, Congress already has bills introduced that would make the adoption tax benefits permanent. Because adoption tax benefits seem to have large, bipartisan support, the sooner any change is made that would make them permanent, the sooner employers could consider their long-term strategies for the adoption assistance they will offer.

VII. Conclusion
The evolution of the exclusion from gross income for employer adoption assistance for adoptions of children with special needs has left section 137 confusing. In attempting to change the law to allow for the exclusion regardless of expenses, legislators have created some ambiguities that should be corrected to make the law consistent with its intent. Then the IRS could implement that intent in its administration of this particular provision.