# Tax Impact

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Tax Tips

# Adopting a child? Tax benefits can help defray the cost

If you're adopting a child, or plan to do so in the future, you know that the process can be expensive. Although expenses are minimal for adoptions through the foster system, the cost of adopting a child through a private agency averages around $43,000 in the United States. Fortunately, there are tax benefits that can help offset some of the costs.

Specifically, there are two tax benefits for adoption: a tax *credit* for qualified adoption expenses and an income *exclusion* for employer-provided adoption assistance. Both are subject to a maximum amount, and both are phased out for higher-income taxpayers. Here are the details.

## Qualified expenses

Qualified adoption expenses for the credit and exclusion include:

- Reasonable and necessary adoption fees,
- Attorney fees and court costs,
- Travel expenses (including meals and lodging), and
- Other expenses directly related to, and for the principal purpose of, legally adopting an eligible child.

An eligible child is either 1) under 18 or 2) physically or mentally incapable of self-care. However, qualified adoption expenses don't include expenses related to adopting your spouse's child.

## Income limits and maximum benefits

Both the credit and exclusion are phased out once your modified adjusted gross income (MAGI) reaches certain levels. (MAGI is adjusted gross income with certain additions and subtractions.) For 2023, adoption tax benefits begin to phase out at MAGI of $239,230 and are eliminated once MAGI reaches $279,230.

The dollar limit on adoption benefits ($15,950 per child in 2023) applies separately to the credit and the exclusion. That means you can claim both benefits in connection with the same adoption, but you can't claim them for the same expenses. IRS rules require you to claim any allowable income exclusion before claiming any allowable credit.

Suppose, for example, that in 2023, you pay $15,950 in qualified adoption expenses in connection with an adoption that's finalized the same year. In addition, your employer reimburses you for $5,000 of these expenses. Assuming your MAGI is less than $239,230, you can exclude the $5,000 reimbursement from your gross income. This reduces your expenses for purposes of the credit by $5,000, so your credit is limited to $10,950. If, on the other hand, your qualified adoption expenses are $20,950, you're entitled to exclude $5,000 from income and claim the full $15,950 credit.

The credit isn't refundable. But it can be carried forward for up to five years.

## Timing of the credit

Special rules apply to the timing of the credit. They vary depending on when you pay the expenses, whether your adoption is domestic or foreign, and when the adoption is finalized (if at all).

For a domestic adoption (meaning adoption of a child who's a U.S. citizen or resident when the adoption effort begins), qualified expenses paid before the year the adoption becomes final are allowable as a credit (subject to the dollar limit) for the year following the year they're paid (even if the adoption is never finalized). For a foreign adoption, qualified expenses are allowable as a credit (subject to the dollar limit) for the year in which it becomes final (whether they're paid in that year or earlier).

Once an adoption becomes final (whether it's domestic or foreign), qualified expenses paid during or after that year are allowable as a credit (subject to the dollar limit) for the year of payment.

Be aware that the credit limit for a particular year must be reduced for expenses paid and claimed as credits in previous years in connection with the same adoption effort. For example, if you claimed a $5,000 credit in 2022 (for expenses paid in 2021) in connection with a domestic adoption and pay another $15,950 in qualified expenses in 2023, when the adoption is finalized, your maximum credit in 2023 is $10,950 ($15,950 minus $5,000).

## Special rules for adopting a child with special needs

If you adopt a child with special needs, you may be eligible for tax benefits, regardless of whether you or your employer actually pay any qualified adoption expenses. Note, however, that "special needs" has a specific meaning. For purposes of the credit and exclusion, a child has special needs if:

- He or she is a U.S. citizen or resident when adoption efforts begin,
- A state determines that the child can't or shouldn't be returned to his or her parent's home, and
- The state determines that the child probably won't be adoptable unless assistance is provided to the adoptive family.

If you adopt a child who meets this definition, you may be eligible for the maximum credit, even if you pay no qualified adoption expenses. You may also be eligible for the maximum exclusion, regardless of whether your employer pays any expenses, if your employer has a written qualified adoption assistance program.

Also, in determining the dollar limit, qualified expenses paid and claimed as a credit in connection with an unsuccessful domestic adoption must be combined with expenses paid in connection with a subsequent domestic adoption attempt (successful or not).

## Joint filing requirement for married couples

Although individuals can claim adoption tax benefits, married couples who wish to claim the credit or exclusion must file a joint return. However, there's an exception for couples who are separated and meet certain other requirements.

Couples who filed as married filing separately in a year when qualified expenses were paid may need to amend those returns to change their filing status to married filing jointly to claim the credit or exclusion. Keep in mind, though, that changing your filing status may affect your eligibility for other tax benefits.

### Know the costs

If you're contemplating adopting a child, familiarize yourself with the various expenses involved. Consult your tax professional to help calculate the potential tax benefits for an accurate picture of the total cost. ■

*Section 179D*

# Congress enhances tax deduction for energy-efficient buildings

The Inflation Reduction Act (IRA) significantly enhanced the Section 179D deduction for energy-efficient commercial building improvements placed in service after 2022. Among other things, the IRA nearly tripled the maximum deduction to $5 per square foot under certain circumstances and made it easier for improvements to qualify for the deduction. The IRA also expanded eligibility for the deduction to include real estate investment trusts (REITs) as well as designers of buildings owned by nonprofit organizations, religious organizations, tribal organizations, and nonprofit schools or universities.

### Deduction basics

For more than 15 years, the Sec. 179D deduction has allowed owners of new or existing commercial buildings to deduct the cost of certain improvements. The deduction is also available to tenants who make improvements and to certain designers (such as architects or engineers) of government-owned buildings. Originally, the maximum deduction was $1.80 per square foot, but legislation passed in 2020 called for that amount to be adjusted for inflation. In 2022, the maximum deduction was $1.88 per square foot.

The Sec. 179D deduction is available for new construction as well as additions to or renovations of commercial buildings of any size. (Multifamily residential rental buildings that are at least four stories above grade also qualify.) Eligible improvements include depreciable property installed as part of a building's interior lighting system, HVAC and hot water systems, or the building envelope.

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Previously, to be eligible, an improvement had to be part of a plan designed to reduce annual energy and power costs by at least 50% relative to applicable industry standards, as certified by an independent contractor or licensed engineer. Partial deductions (up to 63 cents per square foot) were also available for improvements to any one of the previously mentioned building systems that achieved certain energy savings.


### IRA enhancements

The IRA makes it easier to qualify for the deduction by reducing the minimum required energy savings from 50% to 25%. It also eliminates partial deductions. Instead, the base deduction is calculated using a sliding scale, ranging from 50 cents per square foot for improvements that achieve 25% energy savings to $1 per square foot for improvements that achieve 50% energy savings.

Projects that meet specific prevailing wage and apprenticeship requirements are eligible for bonus deductions. Such deductions range from $2.50 per square foot for improvements that achieve 25% energy savings to $5 per square foot for improvements that achieve 50% energy savings.

In another big change, the IRA allows taxpayers to claim a Sec. 179D deduction for the same building as often as every three years (four years in some cases). Previously, the $1.88 per square foot maximum was a lifetime cap.

### Previous improvements

If you believe you're eligible for Sec. 179D deductions for energy-efficient improvements made in previous years, it might not be too late to claim them. One option is to amend your return for the tax year in which the improvements were made. Generally, you have three years from the date the original return was filed to file an amended return.

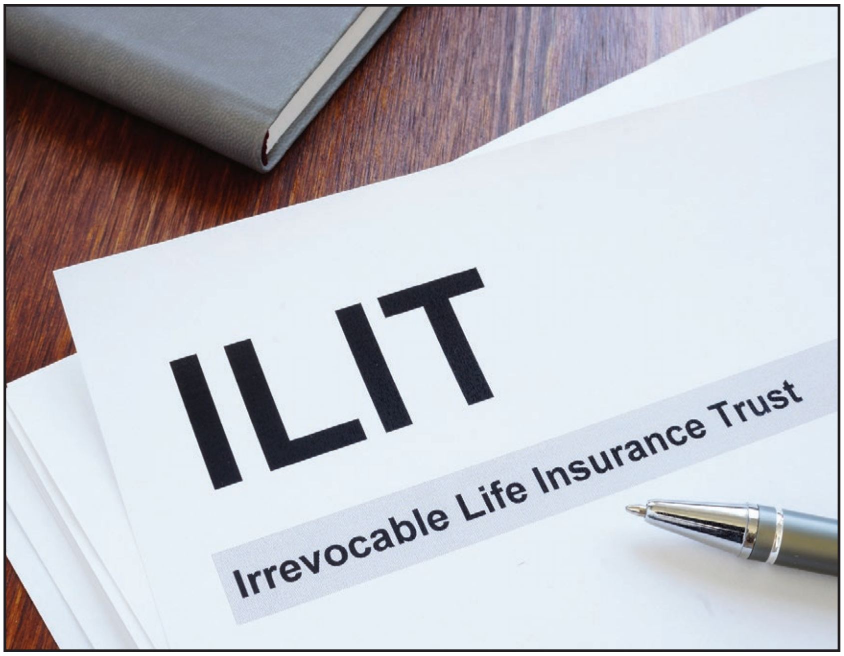
Another option, which doesn't require an amended return, is to file Form 3115, "Application for Change in Accounting Method," to claim catch-up deductions in the current tax year. This option is available only for building owners or tenants, not designers. Keep in mind that if you claim Sec. 179D deductions for previous years, they'll be based on the version of Sec. 179D that was in effect when the improvement was placed in service.

### Energy efficiency pays off

Investing in making a building greener can pay off, not only in reduced energy costs, but also in valuable tax deductions. Contact your tax advisor for more information. ■

# Consider the use of an ILIT to avoid estate tax

Holding a life insurance policy can provide peace of mind if you have concerns about your loved ones' financial well-being after your death. Whether you "hold" the policy or a trust holds the policy can result in different tax outcomes. In short, if you're left holding the policy at death, its proceeds will be included in your taxable estate and may be subject to estate taxes. To




avoid this result, consider creating an irrevocable life insurance trust (ILIT) to hold the policy.

## Learn the basics

Life insurance proceeds will be included in your estate if you possess any "incidents of ownership." This goes beyond mere ownership of the policy. If you have the right to amend the policy — say, by changing beneficiaries — or you can borrow against the cash value, it's treated as an incident of ownership.

> ***There are a few pitfalls to watch out for when transferring an insurance policy to an ILIT.***

A common method for avoiding these estate tax complications is to use an ILIT. This may be accomplished by setting up the trust as the owner of the policy when the coverage is purchased or by transferring an existing policy to the trust.

For starters, the trust must be "irrevocable," as the name states. In other words, you must relinquish any control over the ILIT, such as the right to revise beneficiaries or revoke the trust. You shouldn't be the trustee of the ILIT that owns insurance on your life. Generally, such an arrangement will be treated as an incident of ownership. You can, however, name another family member or a knowledgeable professional as the trustee.

Typically, you'll designate the ILIT as the primary beneficiary of the policy. Upon your death, the proceeds are deposited into the ILIT and held for distributions to the trust's beneficiaries. In most cases, this will be your spouse, children, grandchildren or other family members.

## Beware the pitfalls

There are a few pitfalls to watch out for when transferring an insurance policy to an ILIT. For example, if you transfer an existing policy to the ILIT and die within three years of the transfer, the proceeds will be included in your taxable estate. One way to avoid this is to have the ILIT purchase the policy on your life and then fund the trust with enough money over time to pay the premiums.

Note that the ILIT must be funded so the trust is able to pay the premiums on the policy. Choose a separate bank account to be used for this purpose.

## Preserve your wealth

Life insurance is a powerful estate planning tool. It creates an instant source of wealth and liquidity to meet your family's financial needs after you're gone. To shield its proceeds from estate taxes, thus ensuring more money for your loved ones, consider transferring your policy to an ILIT. Your estate planning advisor can help with this process. ■

## Now may be the time for a Roth conversion

If you've watched the value of your retirement accounts shrink in recent months, there may be a silver lining: It's an ideal time to convert your IRA or 401(k) plan into a Roth account. Roth IRAs and Roth 401(k)s offer many attractive benefits, including tax-free withdrawals of earnings and contributions and no required minimum distributions when you reach age 72. When you convert a traditional account into a Roth account, the amount you convert is fully or partially taxable in the year of conversion. But doing a conversion when the value of your account has dipped generally minimizes the overall tax hit. ■


## Rising interest rates boost interest in certain estate planning vehicles

High interest rates favor certain estate planning vehicles over others. For example, charitable remainder annuity trusts (CRATs) are more effective when interest rates are high. Why? Because their performance is tied to an IRS-prescribed interest rate called the Section 7520 rate. A CRAT pays the donor income for life or a term up to 20 years, after which its remaining assets are given to charity. When you contribute assets to a CRAT, you're entitled to a charitable income tax deduction (subject to applicable limits) equal to the present value of the charity's remainder interest. A higher Sec. 7520 rate equates with a higher value for the remainder interest — and a bigger tax deduction.

Qualified personal residence trusts (QPRTs) also perform better as interest rates increase. On the other hand, grantor retained annuity trusts (GRATs), charitable lead annuity trusts (CLATs) and intentionally defective grantor trusts (IDGTs) tend to do better when interest rates are low. ■

## Sales tax nexus inquiry letters: Handle with care

Most states impose sales tax collection obligations on out-of-state businesses that have a nexus, or connection, with the state. Nexus may be based on 1) a physical presence in the state (brick-and-mortar outlets, for example) or 2) an economic presence in the state (usually based on a particular sales level).

In an effort to determine whether out-of-state businesses are subject to their sales tax laws, many states send out "nexus inquiry letters" to businesses they believe may have a nexus with the state. If your business receives one of these letters — which are often in the form of a questionnaire — handle your response carefully. Typically, these questionnaires consist primarily of yes/no questions that can make it difficult to convey the nuances of your company's activities in the state. To avoid inadvertently triggering further inquiry or even a sales tax audit, consult your tax advisor before responding. Consider preparing a letter describing your activities in lieu of the questionnaire, if permitted. ■