

TAX TALK

By Tim Kelly, Esq.

WATCH YOUR INCOME AND THE CHILD CREDIT

If you have children, watch your taxable income (as determined by your adjustable gross income) as it approaches \$110,000 (\$75,000 if you are single or head of household). The \$600 credit, available for each child under seventeen years of age, begins to “phase-out” at this point, at the rate of \$50 per \$1,000 of income. This constitutes a hidden tax increase when earnings go above this point. The credit completely disappears at various levels above \$110,000, depending on how many children are eligible.

DISPUTED DEPENDENT EXEMPTIONS

A reminder to non-custodial parents who were never married to the other parent of a child. You are entitled to claim that child as a dependent if you meet all the dependency tests. These tests include providing over half of the support for the child. I have litigated this issue before the US Tax Court and can say with certainty that good record-keeping will win for you on this issue. A dependent exemption may be worth up to two thousand dollars depending on your income, so it is well worth the effort. The Tax Court is very skeptical of any case unless records are introduced clearly showing the expenditures of one parent in relation to the expenditures of both parents for the support of a child.

This rule is in contrast to the opposite situation, where the parents are separated or divorced. In that case, the custodial parent is deemed by law to have provided over half the support. But once again, disputes may arise where good recordkeeping can save the day. I find this to be true where both parents split custodial time evenly. If there is a legal dispute, the winner will be the parent who logged every minute of custodial time and can prove the child was with them over fifty percent of the year, thus making them, in the absence of an agreement or court order to the contrary, the custodial parent.

Speaking of custody and court orders, California family law courts have no authority to grant a dependent exemption for federal tax purposes. The exemption (again, for divorced or separated parents) falls to the custodial parent. The exemption may only be used by the non-custodial parent if IRS Form 8332 (or its equivalent) is signed by the custodial parent. If a family law wants to force the transfer of a dependent exemption, it must do so by ordering the custodial parent to execute the necessary document. This action has been held to be within the power of the superior court.

WARNING ON ADOPTIONS

Each year, for a wide variety of reasons, more and more of my police clients are turning to adoption to bring more children into their lives. A substantial income tax break exists for these compassionate families, but substantial tax planning may be required to avoid losing the benefits of this program. In the last year I had an officer who cashed out a

retirement account in order to pay for an adoption. Because he had no place to turn for good tax planning, he inadvertently increased his income to the point where he was ineligible to receive the \$5000 (the 2001) credit to which he otherwise would have been entitled.

A nonrefundable tax credit of up to \$10,000 per child is available for qualified adoption expenses under Internal Revenue Code (IRC) Section 23. An individual must apply the credit for the tax year following the year the qualified adoption expenses are paid unless the expenses are incurred in the year the adoption becomes final. In the case of a special needs adoption after 2001, the credit is available in the year the adoption is finalized, regardless of whether the taxpayer has qualified adoption expenses. To claim the credit, an individual must provide available information about the name, age, and taxpayer identification number of each adopted child.

An individual is eligible for adoption if he or she is not 18 years old when the adoption takes place or is physically or mentally incapable of self-care. An individual is a child with special needs if he or she is a citizen or resident of the United States, a state has determined that the child cannot or should not be returned to the parents, and the child has a condition that requires state adoption assistance.

Qualified adoption expenses include adoption fees, court costs, attorneys' fees, and other expenses related to an adoption. Expenses do not include fees incurred in violation of state or federal law, in carrying out a surrogate parenting arrangement, or for adopting the child of a spouse. Expenses reimbursed under an employer program are not qualified expenses.

An individual cannot claim a credit if the individual has deducted the expenses already; receives a federal, state, or local grant to cover the expenses; or if the expenses are paid under an adoption assistance program. An individual may carry forward for up to five years any unused credit.

A credit for an international adoption is not available unless the adoption actually becomes final. For a domestic adoption, a credit may be available for even an unsuccessful adoption attempt.

Now here is where tax planning comes into play. A \$10,000 tax credit is a lot of money. But the credit is "passed-out" in 2002 for taxpayers with modified adjusted gross income above \$150,000, and is fully phased out at \$190,000. Because of the high salaries (to go with the high cost of living) in many parts of the state, many couples considering an adoption should plan to reduce their taxable income to stay below \$150,000. This can be done by maximizing contributions to deferred comp (457) and 401(k) plans.

Couples who use ordinary tax-preparers should consult a more sophisticated tax advisor if contemplating adoption because of all the prerequisite conditions of obtaining this tax benefit.

HIGH MEDICAL EXPENSES

On a very similar topic, I want to address the use of in-vitro fertilization (IVF) and the tax consequences which may result. In my experience, the vast majority of medical insurance programs do not cover this procedure, which frequent can cost between ten and twenty thousand dollars. The cost, however, is secondary to couples who really want children.

There are several thresholds which must be crossed before any medical expense becomes truly "deductible." First, the medical expenses must exceed 7.5% of the taxpayers' adjusted gross income. Next, the taxpayers must have enough itemized deductions to exceed the standard deduction. In 2001 this was \$7600 for joint filers. Finally, the expenses must qualify under the standards of the Internal Revenue Code. For most people, none of the following advice will make any difference in tax liability. Most police officers are covered by insurance, so that an officer earning \$60,000 per year would have to have in excess of \$4,500 in qualified medical expenses before a single dollar of medical expense may be deducted.

IVF, almost without exception, passes muster on all three of these tests. Because it does, more tax planning is in order. For example, if a couple intends to spend \$15,000 on an IVF procedure, chances are they will incur other medical expenses within the same year. These expenses ordinarily would have been too small to overcome the thresholds I spoke of, but coupled with the IVF procedure become deductible. Often many of these expenses are also associated with fertility procedures, where medical fees, tests and drugs may be quite expensive.

In order to maximize the benefit of this investment in medical expense in a year where IVF will be paid for, records should be kept of other deductible medical expenses. These include unreimbursed costs for eye exams and procedures (including laser surgery), prescription (but not over-the-counter) drugs, mileage to and from medical providers and hotel costs incurred while obtaining medical care. Also very important are co-pays and deductibles for doctors and dentists. The IRS also recently approved weight-loss programs (but not food) as medical costs. Any out of pocket insurance premiums also count, except for those taken out by an employer (these are already pre-tax and therefore not deductible).

Another way to maximize medical deductions in a year is to reduce income. Take comp time instead of overtime and cutback on income as much as possible. Maximize contributions to deferred comp and 401(k) programs. These measures reduce the adjusted gross income (AGI), from which the 7.5% threshold is derived. The lower the AGI, therefore, the more medical expenses will be allowed. By concentrating elective medical procedures into a year in which income is kept to a minimum, tax liability may be significantly lowered.

Tim Kelly is an honors graduate of the McGeorge School of Law. He specializes in income tax planning and tax litigation concerning individuals, businesses and tax-exempt organizations. He a retired police sergeant, having spent 24 years with LASD, Beverly Hills PD, Sacramento SO and Davis PD. He is entitled to practice before the Internal Revenue Service and is admitted to practice before all federal courts in California. Tim welcomes questions on his articles and he may be reached at www.timkelly.com.