2027

Adoption FSA

Plan Summary



Adoption FSA Plan Requirements

The Small Business Job Protection Act of 1996 added Code Sections 137 and 23, relating to employer-provided adoption assistance programs and the adoption credit, respectively. Section 137 relies on Section 23 for some of the definitions and rules applicable to an adoption assistance program, and the two Sections essentially work in tandem.

Adoption Assistance Exclusion and Adoption Credit. The maximum amount that may be excluded from an employee's gross income for the adoption of a child through an adoption assistance program is $18,250 for 2027. This amount is the same as what may be excluded from that employee's gross income for expenses incurred by an employer for qualified adoption expenses under the same program. In 2027, the available adoption credit begins to phase out for taxpayers with modified adjusted gross income in excess of $273,680 and is completely phased out for taxpayers with modified adjusted gross income of $313,680 or more.

Through an Adoption FSA, an employee may claim an exclusion under Section 137. If there are expenses greater than the Adoption FSA election, the participant may also claim a tax credit under Section 23. The only requirement is that separate expenses must be used in claiming reimbursement from an Adoption FSA and the credit. Thus, an employee with at least $36,500 in qualifying expenses can take full advantage of both.

If an employer reimburses qualifying adoption expenses of an eligible child through an Adoption FSA, the reimbursement will not be included in the employee's taxable wages and is not subject to federal income tax withholding. Unlike other FSA benefits, the reimbursement will be counted as FICA wages.

The employer reports the amount of the Adoption FSA reimbursement on the employee's Form W-2 for the year. The employee must complete and file Form 8839 with his or her federal income tax return to exclude such amount from taxable income.

Adoption FSAs must meet the following four requirements to qualify for the exclusion from federal income taxes under Code Section 137.

1. **Separate Written Plan and Notification:** Under IRS Notice 97-9, the exclusion from income tax withholding is not available unless "before adoption expenses are incurred, the written plan is in existence and the employee receives notification of the existence of the plan."
2. **Nondiscrimination in Eligibility:** Adoption FSAs must benefit employees who qualify under a classification established by the employer that does not discriminate in favor of highly compensated employees (within the meaning of Code Section 414(q)).
3. **Principal Owner's Limitations:** Five percent owners cannot receive more than five percent of the Adoption FSA reimbursements in the plan year.
4. **Claims Substantiation:** Notice 97-9 requires reasonable procedures to substantiate that reimbursements are for qualified adoption expenses.

Qualifying 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, and whose principal purpose is for, the legal adoption of an eligible child.

An adoption assistance program that meets the requirements of Section 137 is a qualified benefit under Section 125 and may be offered on a salary reduction basis through a cafeteria plan. In the case of an Adoption FSA, the cafeteria plan and flexible spending account rules come into play as follows:

Use-It-or-Lose-It Rule: This rule does apply to Adoption FSAs. Both an annual limitation (based on the employee's contribution to the FSA for the year) and an overall limitation will apply to Adoption FSA requirements.

Contribution Elections: Elections to start, increase, decrease or stop Adoption FSA contributions may only be made for the next plan year or for the remaining portion of the current plan year pursuant to §1.125-4 regulations.

Claims Incurred Rule: Qualified adoption expenses must be incurred during a period of coverage elected by the participant. Expenses incurred before the participant elects to contribute to the Adoption FSA will not be eligible for reimbursement.

Uniform Coverage: In parallel to Dependent Care FSAs, Adoption FSAs should not be subject to the uniform coverage rule that applies to Medical FSAs. If this is the case, the employer would only be required to reimburse qualifying adoption expenses up to a participant's Adoption FSA account balance.

FSA Claims Substantiation: In addition to Section 137 substantiation requirements, an Adoption FSA would also be required to meet the substantiation requirements applicable to FSAs.

Change in Status: Employees may change their elections for Adoption FSA benefits upon: 1) the commencement of an adoption proceeding; 2) an increase in the number of the employee's dependents due to a placement for adoption or an adoption; and 3) the termination of an adoption proceeding. The regulations also require any change due to the above events be on account of and consistent with the event (i.e. the consistency rule). The regulations consider any change that affects eligibility or the amount of adoption expenses to correspond with the change in status.

Cost or Coverage Changes: In addition to the three status changes above, participants may also make election changes that minimize the "Use-It-Or-Lose-It" risk under the significant cost or coverage rules.

Income Tax Treatment: Adoption FSAs are exempt from federal income tax. FICA (Social Security and Medicare) as well as federal and state unemployment tax remain taxable. State tax is exempt except for Arkansas, Mississippi, New Jersey, Pennsylvania and Puerto Rico. A matrix outlining the tax treatment is included with this proposal.

Domestic Adoptions: If the eligible child is a U.S. citizen or resident of the United States. Participants can take the Adoption Credit or be reimbursed from an Adoption FSA even if the adoption never becomes final. Under Code Section 137(a) reimbursements of qualifying adoption expenses can be paid in any plan year and remain free of federal income tax as long as the reimbursement is in connection with the adoption of an eligible child. However, because the FSA rules are also applicable, the reimbursed expenses must have been incurred during the period of Adoption FSA coverage.

Foreign Adoptions

If the eligible child is not a U.S. citizen or resident, participants cannot take the Adoption Credit or be reimbursed from an Adoption FSA unless the adoption becomes final. Since Adoption FSA participants will have qualifying adoption expenses for the years prior to the adoption becoming final, these expenses could be used to claim the adoption credit and then when the adoption becomes final the expenses incurred thereafter could be reimbursed through the Adoption FSA.

Child with Special Needs

An eligible child is a child with special needs if he or she is a citizen or resident of the United States (including the District of Columbia and U.S. possessions) and a state determines the child cannot or should not be returned to his or her parents' home and probably will not be adopted unless adoption assistance is provided to the adoptive parents. A foreign child cannot be treated as a child with special needs. Factors used by states to determine if a child has special needs could include: the child's ethnic background; the child's age; whether the child is a member of a minority or sibling group, or whether the child has a medical condition or physical, mental or emotional handicap.

A matrix is included with this proposal that will be provided to employees to help them determine whether or not to participate and the amount to elect.

Domestic, Foreign and Special Needs Adoption Matrices

Domestic Adoption: If the eligible child is a U.S. citizen or resident of the United States, you can take the Adoption Credit or be reimbursed from an Adoption FSA even if the adoption never becomes final. You must be an eligible participant in an Adoption FSA at the time expenses are incurred to receive reimbursement through an Adoption FSA.

Adoption Credit		**Adoption FSA**	
Domestic Adoption		Domestic Adoption	
If you pay qualifying expenses in:	Then take the credit in:	If you incur expenses in:	Reimbursement is made in:
Any year before the year the adoption becomes final.	The year AFTER the year of the payment.	Any year before the year the adoption becomes final.	The plan year the expenses are incurred and you are a participant in the Adoption FSA.
The year the adoption becomes final.	The year the adoption becomes final.	In a year prior to your participation in the Adoption FSA.	Not eligible for reimbursement from Adoption FSA. Use Adoption Credit for expenses.
Any year after the year the adoption becomes final.	The year of the payment.	Any year after the year the adoption becomes final.	The plan year the expenses are incurred and you are a participant in the Adoption FSA.

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Foreign Adoption: If the eligible child is not a U.S. citizen or resident, you cannot take the Adoption Credit or be reimbursed from an Adoption FSA unless the adoption becomes final.

You must be an eligible participant in an Adoption FSA at the time expenses are incurred to receive reimbursement through an Adoption FSA. Since Adoption FSA participants will have qualifying adoption expenses for the years prior to the adoption becoming final, these expenses could be used to claim the Adoption Credit and then, when the adoption becomes final, the expenses incurred thereafter could be reimbursed through the Adoption FSA.

Adoption Credit		**Adoption FSA**	
Foreign Adoption		Foreign Adoption	
If you pay qualifying expenses in:	Then take the credit in:	If you incur expenses in:	Reimbursement is made in:
Any year before the year the adoption becomes final.	The year the adoption becomes final.	Any year before the year the adoption becomes final.	Not eligible for reimbursement. Use Adoption Credit.
The year the adoption becomes final.	The year the adoption becomes final.	In a year prior to your participation in the Adoption FSA.	Not eligible for reimbursement. Use Adoption Credit.
Any year after the year the adoption becomes final.	The year of the payment.	Any year after the year the adoption becomes final.	The plan year the expenses are incurred and you are a participant in the Adoption FSA.

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Child with Special Needs: An eligible child is a child with special needs if he or she is a citizen or resident of the United States (including the District of Columbia and U.S. possessions) and a state determines that the child cannot or should not be returned to his or her parents' home and probably will not be adopted unless adoption assistance is provided to the adoptive parents. A foreign child cannot be treated as a child with special needs. Factors used by states to determine if a child has special needs could include: the child's ethnic background; the child's age; whether the child is a member of a minority or sibling group, or whether the child has a medical condition or physical, mental or emotional handicap.

You must be an eligible participant in an Adoption FSA at the time expenses are incurred to receive reimbursement through an Adoption FSA.

Adoption Credit		**Adoption FSA**	
Special Needs Adoption		Special Needs Adoption	
If you pay qualifying expenses in:	Then take the credit in:	If you incur expenses in:	Reimbursement is made in:
Any year before the year the adoption becomes final.	The year the adoption becomes final.	Any year before the year the adoption becomes final.	Not eligible for reimbursement. Use Adoption Credit.
The year the adoption becomes final.	The year the adoption becomes final.	In a year prior to your participation in the Adoption FSA.	Not eligible for reimbursement. Use Adoption Credit.
Any year after the year the adoption becomes final.	The year of the payment.	Any year after the year the adoption becomes final.	The plan year the expenses are incurred and you are a participant in the Adoption FSA.

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