# TAX ASPECTS OF FAMILY FORMATION

by Bill Singer and John T. Passante

The creation or expansion of families through adoption and surrogacy raises tax questions, some of which are unsettled.

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Intended parents ask if they may properly deduct the costs of surrogacy and gamete acquisition from their taxable income. Adoptive parents ask if they may properly deduct the cost of adoption from their taxable income or receive a tax credit for the cost of the adoption. Gestational carriers and gamete donors question if they must declare their compensation as taxable income. Parties to a surrogacy agreement must decide whether to reimburse travel at the Internal Revenue Service (IRS) medical or business mileage rate. Surrogacy agencies wonder if they are required to issue 1099 forms to gestational carriers who receive compensation. This article addresses these issues.

## Adoption Tax Credit

Individuals and couples seeking to create or expand their families through the adoption of an eligible child[1] may receive preferential tax treatment.

The adoption credit is a dollar-for-dollar reduction against tax liability. This credit is better than a tax deduction. With the changes in the 2017 tax act, most tax deductions have diminished value to the average taxpayer.

For the 2017 tax year, the IRS allowed an adoption tax credit of up to $13,570 for qualified expenses paid to adopt an eligible child.[2] The adoption tax credit can reduce tax liability to zero. If the credit is greater than the tax owed, the unused credit can be carried forward for up to five years.

For purposes of the tax credit, the Internal Revenue Code (I.R.C.) Section 213(a) defines qualified expenses as all reasonable and necessary adoption fees, agency fees (including home study), court costs, attorney fees, traveling expenses (including 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.

There is a phase out of the adoption credit based on modified adjusted gross income (MAGI). There is no limitation on the credit if an individual's MAGI in 2017 is below $203,540. The credit phases out between $203,540 and $243,540.

The year in which the taxpayer may claim the adoption tax credit depends on when the expenses are paid, whether the adoption is domestic or foreign, and if the adoption is finalized.

When claiming the adoption tax credit, taxpayers must file Form 8839 with their personal income tax returns.

The I.R.C. also offers an exclusion from income for employer-provided adoption assistance. For example, if a taxpayer's employer provides $5,000 toward the cost of the adoption of an eligible child, that $5,000 will not count as part of the taxpayer's taxable income.

There are even more generous rules for the tax credit and tax exclusion of employer-provided assistance where the taxpayer is adopting a child with special needs. Here, the term 'special needs' does not necessarily refer to a disability but rather to a child who, in the judgment of a state, is difficult to place for adoption. To qualify as a child with special needs, the child must be a citizen or resident of the United States or its possessions, a state must determine that the child cannot or should not be returned to the home of his or her parents, and a state must determine that the child probably could not be placed with adoptive parents unless assistance is provided.

## IRS Mileage Rates

The IRS allows a deduction or reimbursement for use of a vehicle in certain circumstances. If a vehicle is used for business purposes, the 2018 business mileage rate is 54.5 cents per mile; for medical purposes, the 2018 IRS rate is 18 cents per mile.[3]

For gestational carriers who must travel to perform duties, some agreements reimburse carriers at the IRS business mileage rate; other agreements use the IRS medical mileage rate.

If a gestational carrier is being compensated for her services, a compelling argument can be made that the gestational carrier should receive mileage reimbursement at the business rate. Alternatively, if it is a compassionate arrangement where the carrier is not receiving compensation for her services, then one might argue that the medical reimbursement rate is more appropriate. In compassionate surrogacies, some intended parents choose to show appreciation to their carrier by opting to use the higher business mileage rate. There is no consistency on this issue.

## Deductibility of Medical Expenses Related to Gamete Donation and Surrogacy

Employing the tools available through assisted reproductive technology (ART) can be expensive. Acquisition of donor gametes and use of a gestational carrier, including reimbursement of her expenses, necessitates a range of costs.

New Jersey requires a level of mandated insurance coverage for certain types of infertility.[4] Health insurance plans and flexible spending accounts may provide some relief. But beyond those measures, do unreimbursed expenses—medical, legal, and otherwise—qualify for deduction as medical care under the I.R.C.?

I.R.C. § 213(a) allows a deduction for "the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent."

I.R.C. § 213(d)(1)(A) further defines medical care as amounts paid "for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body."

# New Jersey requires a level of mandated insurance coverage for certain types of infertility.

Judicial and administrative interpretations of these tax provisions make a distinction between medical infertility and social infertility. Medical infertility is where reproductive organs are incapable of producing viable gametes or, in the case of women, inability to gestate a fetus full term. Social infertility is where an individual's social circumstances prevent him or her from reproducing. This includes same-sex couples, single individuals of either sex who desire to become parents, and couples where one or both members are transgender.[5]

Generally, a medically infertile person can use the medical deduction to cover unreimbursed expenses when using ART. In 2003, the IRS issued a private letter ruling about egg donation in a case involving a medically infertile woman.[6] A private letter ruling has limited precedential value.[7]

In that letter ruling, the IRS found that the taxpayer had undergone repeated, unsuccessful attempts using ART to conceive using her own eggs. The taxpayer then used donated eggs. She inquired whether she could deduct expenses related to the donor's fee, the agency fee for finding donor, and making the arrangements between the parties, including expenses of medical and psychological testing of the donor and legal fees.

The private letter ruling held that all unreimbursed expenses, including the egg donor fee, agency fee, donor's medical and psychological testing, and legal fees for contract preparation, were allowable medical care expenses deductible under Section 213.

In an earlier letter, in 2002, the IRS took the same position as in 2003: Medical and legal expenses incurred in connection with medical procedures are deductible. However, the IRS allows such deductions only where the expenses are for the taxpayer, the taxpayer's spouse, or dependents. According to the IRS's 2002 letter, intended parents in a surrogacy arrangement cannot deduct medical or legal expenses paid for the gestational carrier or the unborn child because those individuals are not the taxpayer, the taxpayer's spouse, or dependents. In the presence of an order of parentage, issued pursuant to a gestational carrier statute, why should medical expenses for an unborn child carried by a gestational carrier be treated differently for tax purposes than medical expenses incurred for an unborn child of the taxpayer, the taxpayer's spouse, or a dependent? Given that gestational carrier statutes indicate governmental approval of surrogacy, this issue seems ripe for reevaluation by the IRS.

Where does that leave other families who are socially infertile and who seek to become parents? Can same-sex couples, single people, or a couple where one or both members are transgender take deductions for expenses incurred in family creation?

In the tax case *Magdalin v. Commissioner,* the tax judge found against the taxpayer who was socially infertile.[8] In *Magdalin,* the taxpayer, an unmarried man, incurred medical expenses attributable to using in vitro fertilization (IVF) and a gestational surrogacy to create his family. He claimed deductions for donor and carrier fees, fees paid to clinics and agencies, and costs of medical care and pharmaceuticals.

The tax judge distinguished Magdalin from the egg donor private letter ruling. Unlike the taxpayer in the letter ruling, Magdalin did not demonstrate a medical reason for needing the procedures undertaken. At all times, the taxpayer had normal levels of sperm count and motility. The taxpayer had had children previously conceived and born with a former spouse and without the use of ART techniques. The judge rejected the argument that his social infertility entitled him to benefit from the medical deduction rules. The First Circuit Court of Appeals affirmed that holding.[9]

A Florida taxpayer raised similar claims in *Morrissey v. United States*.[10] Morrissey, a gay male in a monogamous relationship, argued that the IRS improperly denied him a deduction for medical expenses he incurred in conceiving a child through the use of in vitro fertilization. He argued that opposite-sex couples have routinely been allowed to deduct these types of medical family planning expenses, even where the expenses were for elective procedures that were not medically necessary.

The IRS asserted that his medical expenses were unnecessary, as he could have conceived a child through a sexual relationship with a woman. Morrissey countered that his choice to raise a family with his same-sex partner is protected from discrimination by the Constitution under *Obergefell v. Hodges,*[11] the marriage equality decision.

A Florida federal district court judge upheld the IRS.[12] The 11th Circuit Court of Appeals affirmed that decision.[13] In finding against Morrissey, the courts distinguished between medical infertility and social infertility, finding that social infertility did not qualify for tax deductions.

The *Morrissey* court's failure to con-

sider social fertility is at odds with the holdings in *U.S. v. Windsor,*[14] *Obergefell v. Hodges,*[15] and *Pavan v. Smith,*[16] three cases where the U.S. Supreme Court found that federal laws, including tax laws, must be applied equally to same-sex couples. From that perspective, the *Magdalin* and *Morrissey* decisions limit use of the deductions to matters falling within traditional methods of procreation by opposite-sex couples.

Generally, a medically infertile person can use the medical deduction to cover unreimbursed expenses when using ART.

### Are Amounts Paid to Gamete Donors and Gestational Carriers Taxable Compensation?

When a professional, a doctor or a lawyer, receives compensation for services rendered to a client in an ART matter, he or she reports it as income. But what about other participants in the ART transaction who receive compensation? Should a gamete donor or a gestational carrier report what she receives as taxable compensation? From a tax perspective, how should their compensation be treated?

Section 61 (a) of the Internal Revenue Code defines gross income as "all income from whatever source derived" unless specifically excluded under I.R.C. § 101-140. Three exclusions could conceivably cover payments to a gamete donor or a gestational carrier:

- compensation for injury or sickness, "pain and suffering"—Section 104
- child support payment—Section 71(c)
- gift—Section 102

Attorneys drafting ART agreements have employed a variety of descriptions of the payment and compensation with the intent that the consideration exchanged would fall within one of these three exceptions. Ultimately, compensation to gamete donors and gestational carriers does not fall within the scope of these exceptions.

There is one reported egg donor case that analyzes the Section 104 pain and suffering exception and finds the argument deficient.[17]

In 2009, through a matching agency, Perez entered into two egg donation contracts. The agreement provided that "Donor and Intended Parents will agree upon a Donor Fee for Donor's time, effort, inconvenience, pain and suffering in donating her eggs."

The matching agency sent Perez a Form 1099 reporting the $20,000 payment she received as compensation. Perez claimed the compensation was for "pain and suffering," and did not report the income on her personal income tax return. She provided details of the egg retrieval process, including the intrusive physical examinations and the requirement to self-administer hormonal injections.

Perez relied on:

- Section 104(a)(2) states that "gross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness."
- Treas. Reg. § 1.104-1(c)(1) states, "Section 104(a)(2) excludes from gross income the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness."

The court found Perez's reliance on Section 104(a) without merit. An advance payment as a waiver of damages for possible personal injury falls outside Section 104 (a)(2). That provision covers payments for injuries sustained prior to a lawsuit or settlement agreement, not for payments negotiated as part of a compensation agreement.

The court found that "[Perez's] physical pain was a byproduct of performing a service contract...and we find that the payments were made not to compensate her for unwanted invasion against her bodily integrity but to compensate her for services rendered."

The decision in *Perez* accords with holdings in cases where blood or blood plasma was sold.[18]

Although there is scant authority on these issues, it is difficult to justify a difference in tax treatment between the gamete donor in *Perez* and a gestational carrier. Both individuals incur pain or discomfort as an inherent part of a medical procedure for which the individual receives compensation negotiated in advance. Neither individual experiences unwanted bodily invasion to which she did not consent.

The gift and child support payment exclusions also do not accord with ges-

tational carrier arrangements. The child support payment exclusion does not apply to unborn children and, in surrogacy arrangements, gestational carriers surrender the child at birth and never incur the expense of caring for a live infant. The gift exclusion does not apply to gestational carrier arrangements because there is no donative intent where intended parents pay negotiated amounts to gestational carriers. Any money paid is compensation for the service of gestating an embryo.

Child support payments are for a "qualifying child" under I.R.C. § 152(c)(1) and (2). Under those provisions, a qualifying child must meet requirements regarding residence, age, and relationship. Payments for an unborn child do not qualify.

To qualify for the gift exclusion, a monetary transfer from donor to donee must have a donative intent. It would be difficult to support an argument that a gift was made where the recipient of the gift has agreed to provide gametes for the taxpayer's use or undertaken a pregnancy, with its attendant possible complications, to enable an intended parent to create a family.

## Tax Consequences of Categorizing Payment as Compensation

If a gamete donor or gestational carrier is receiving taxable compensation, that raises more tax issues. If compensated, is the donor or carrier a salaried employee or an independent contractor? If an employee, the employer is required to pay half of the employee's employment taxes. If an independent contractor, then the independent contractor is responsible for her own self-employment taxes.

The IRS has identified 20 factors to determine whether someone is an employee.[19] Generally, the decision will depend on whether the person receiving the services has control and a right to control the person providing the service.

If it is determined that the donor or carrier is an independent contractor and is receiving more than $600 in a calendar year, and if the person receiving the services is in a trade or business, then he or she is obligated to issue a Form 1099 to the IRS, with a copy to the provider. Penalties for failure to issue a 1099 can range from $250 for failure to provide a correct return to $25,000 for a willful failure.

Treasury Regulation 1.6401-1(e) provides:

> **(i)*Payments required to be reported.*** Except as otherwise provided in §§ 1.6041-3 and 1.6041-4, every person engaged in a trade or business shall make an information return for each calendar year with respect to payments it makes during the calendar year in the course of its trade or business to another person of fixed or determinable income described in paragraph (a)(1)(i) (A) or (B) of this section. For purposes of the regulations under this section, the person described in this paragraph (a)(1)(i) is a payor.

Clearly exempt from that requirement are one-time payments pursuant to an agreement between intended parents and a gestational carrier. But what if the payments are made through an escrow agency business that manages payments under a contract? Or what if the payments are made through a matching agency that brings together a gamete donor with a recipient or links intended parents with a carrier? Or what if an attorney processes payments through an attorney trust account on behalf of a client?

There are no clear answers. Attorneys with years of experience in ART transactions have conflicting viewpoints. ⚖

## Endnotes

1. "An eligible child is an individual who is under the age of 18, or is physically or mentally incapable of self-care." https://www.irs.gov/taxtopics/tc607.
2. IRS website, Topic Number 607 – Adoption Credit and Adoption Assistance Programs. https://www.irs.gov/taxtopics/tc607.
3. https://www.irs.gov/newsroom/standard-mileage-rates-for-2018-up-from-rates-for-2017.
4. N.J.S.A. 17:48-6x.
5. *See generally New Jersey Lawyer,* No. 307, Aug. 2017, page 46, Regulating the Right to Procreate by Kimberly Mutcherson.
6. IRS Private Letter Ruling Number: 200318017, release date 5/2/2003, Index No.: 213.05-00.
7. See I.R.C. § 6110(k)(3) (West 2009).
8. *Magdalin v. Commissioner,* T.C. Memo. 2008-293, aff'd without published opinion, 105 A.F.T.R.2d (RIA) 2010-442 (1st Cir. 2009).
9. *Id.*
10. *Morrissey v. United States,* No. 8:15-cv-2736-T-26AEP, 2016 BL 447323 (M.D. Fla. Dec. 22, 2016).
11. *Obergefell v. Hodges,* 576 U.S. ___ (2015).
12. *Morrissey v. United States,* No. 8:15-cv-2736-T-26AEP, 2016 BL 447323 (M.D. Fla. Dec. 22, 2016).
13. *Morrissey v. United States,* No. 17-10685 (11th Cir. 2017).
14. *United States v. Windsor,* 570 U.S. 744 (2013).
15. *Obergefell v. Hodges,* 576 U.S. ___ (2015).
16. *Pavan v. Smith,* 582 U. S. ___ (2017).
17. *Perez v. Commissioner,* 144 T.C. No. 4, Docket No. 9103-12 (2015).
18. *Green v. Commissioner,* 74 T.C. 1229 (1980).
19. Rev. Rul. 87-41, 1987-1 C.B. 296.