

05-0073  
Audit  
Signed 08/15/2005

BEFORE THE UTAH STATE TAX COMMISSION

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PETITIONER 1 & PETITIONER 2,	)		
	)		
	)	<b>ORDER</b>	
Petitioner,	)		
	)	Appeal No.	05-0073
v.	)		
	)		
AUDITING DIVISION OF	)	Tax Type:	Income Tax
THE UTAH STATE TAX	)		
COMMISSION,	)	Judge:	Phan
	)		
Respondent.	)		

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**Presiding:**

Jane Phan, Administrative Law Judge

**Appearances:**

For Petitioner: PETITIONER 2  
PETITIONER 1

For Respondent: RESPONDENT REPRESENTATIVE 1, Assistant Attorney General  
RESPONDENT REPRESENTATIVE 2, Manager, Income Tax Auditing  
RESPONDENT REPRESENTATIVE 3, Senior Auditor

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for an Initial Hearing pursuant to the provisions of Utah Code Ann. 59-1-502.5, on June 8, 2005.

Petitioner is appealing individual income tax audit deficiencies for the tax year 2001. The Statutory Notice of Estimated Income Tax was issued on December 28, 2004. The amount of additional tax indicated on the notice was \$\$\$\$\$ along with interest of \$\$\$\$\$. The additional tax

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amount resulted from Respondent's disallowance of the \$\$\$\$ claimed as a deduction for adoption expenses. No penalty was assessed with the audit.

APPLICABLE LAW

Utah imposes income tax on individuals who are residents of the state, in Utah Code Ann. §59-10-104 as follows:

...a tax is imposed on the state taxable income, as defined in Section 59-10-112, of every resident individual . . .

State taxable income is defined in Utah Code Ann. §59-10-112 as follows:

"State taxable income" in the case of a resident individual means his federal taxable income (as defined by Section 59-10-111) with the modifications, subtractions, and adjustments provided in Section 59-10-114 . . .

Federal taxable income is defined in Utah Code Ann. §59-10-111 as follows:

"Federal taxable income" means taxable income as currently defined in Section 63, Internal Revenue Code of 1986.

During the tax year at issue, 2001, a deduction from taxable income was allowed for adoption expenses as follows at Utah Code Sec. 59-10-114(2)(c):

The amount of adoption expenses which, for purposes of this Subsection (2)(c), means any actual medical and hospital expenses of the mother of the adopted child which are incident to the child's birth and any welfare agency, child placement services, legal, and other fees or costs relating to the adoption.

An Administrative Rule was adopted to clarify the expenses that qualified for the deduction.

Utah Admin. Rule R865-9I-48 as in effect during 2001 provides in pertinent part as follows:

A. For purposes of the deduction for adoption expenses under Section 59-10-114, adoption expenses include:

1. medical expenses associated with prenatal care, childbirth, and neonatal care;
2. fees paid to reimburse the state under Section 35A-3-308;
3. fees paid to an attorney or placement service for arranging the adoption;
4. all actual travel costs incurred exclusively for the purpose of completing adoption arrangements; and
5. living expenses of the birth mother if paid by the adoptive parents as part of their adoption expenses and if in conformance with Section 76-7-203.

. . .

The Utah Legislature has specifically provided that the taxpayers bear the burden of proof in proceedings before the Tax Commission. Utah Code Ann. §59-10-543 provides the following:

In any proceeding before the commission under this chapter, the burden of proof shall be upon the petitioner . . .

#### DISCUSSION

When Petitioners filed their 2001 Utah Individual Income Tax Return they claimed a deduction for adoption expenses in the amount of \$\$\$\$\$. Respondent disallowed the deduction, which resulted in additional tax due. Whether or not Petitioners are entitled to the deduction, or some portion thereof, is the subject of this appeal.

Utah law, currently and the law in affect during the year at issue, provided for an income tax deduction for adoption expenses. Utah Code Sec. 59-10-114(2)(c) (2001). The language of the statute is clear that the deduction is for medical and hospital expenses of the mother of the adopted child which are “incident to the child’s birth” as well agency, placement, legal and other fees “relating to the adoption.”

Petitioners adopted twin boys on June 19, 2001. Certainly some of the legal and other fees that they claimed were directly related to the adoption. However, additionally included in the claimed deduction amount appears to be amounts related to the surrogacy arrangement through which process a surrogate gave birth to the children who were Petitioners' biological offspring.

Petitioners had retained the services of a COMPANY in STATE. Through this foundation they found a birth mother in STATE and entered into a parenting agreement in STATE. Presumably this arrangement was legal in the state of STATE. Petitioners paid a fee to the foundation for this service and it is unclear if some of the legal fees incurred by Petitioners related to this service or the parenting agreement that they entered into with the surrogate. The surrogate mother went through medical testing and in vitro fertilization procedures, which were paid for by Petitioners and she became pregnant with twins. Petitioners indicated that they paid the surrogate over \$\$\$\$\$, which they state was to pay for living expenses. It was unclear if this was part of the parenting agreement and possibly the amount was as high as \$\$\$\$\$. Petitioners indicated that the surrogate had to stop working and was on bed rest for much of the pregnancy. Petitioners did travel to STATE on several occasions, once to be with the surrogate for an ultra sound.

Under STATE law the surrogate and her husband were the legal parents of the children. Petitioners had to go through the same adoption process to adopt the children after they were born as any other parents who were not related to the adopted child. The expenses incurred by Petitioners to legally adopt the children after they were born were clearly adoption related expenses. The surrogate and her husband signed a written consent voluntarily surrendering and relinquishing all parental rights. Petitioners had to go through the home studies to become adoptive parents that were required

by the state of STATE. They had to file an adoption proceeding in the STATE Circuit Court. They had to travel to STATE to complete the adoption.

At the hearing Petitioners indicated that they could provide a detailed breakdown of their expenses but had not done so at this point as it was their understanding Respondent would not allow any expenses because of the surrogate arrangement. Petitioners indicated that they claimed the expenses in good faith based on their understanding of the law applicable at the time. The Commission notes that no penalties were assessed and Respondent did not argue that this was anything more than a good faith misunderstanding. In addition Petitioners argued that the audit was a result of someone applying the current law and not the law in affect during 2001. However, in making its determination the Commission considers only the state and federal law that was in affect in 2001, and would note that during the appeal process Respondent had been arguing only the law in affect during 2001.

Respondent's representatives argue that in 2001 surrogate parenting agreements with or without consideration violated Utah law so the costs should be disallowed, citing Utah Code. Sec. 76-7-204. They point out that the Internal Revenue Service for the purposes of determining the amount of the adoption credit specifically disallows expenses in carrying out any surrogate parenting arrangement at Internal Revenue Code Sec. 23(1)(d)(1). Further, they argue that even if some expenses qualify for the deduction, the expenses relating to the surrogate arrangement do not qualify as adoption expenses.

The Commission finds that Petitioner is entitled to the deduction for those costs incurred that clearly qualify as adoption expenses, if Petitioner is able to establish the amount of the expenses.

However, surrogacy expenses are not adoption expenses and are not deductible. In this case Petitioners incurred both types of expenses and provided insufficient information to support the amounts that would qualify as adoption related expenses. Clearly expenses relating to the prenatal and neonatal medical care and medical care of the birth mother during the birth of the children, if paid for by Petitioners, are deductible. In addition all the legal, court, and adoption fees and costs that Petitioners incurred after the birth of the children to adopt them are deductible. Petitioners need to provide documentation to establish the amounts of these expenses.

It is also clear that any expense incurred for activities prior to when the children were conceived are not adoption expenses, but instead surrogacy expenses and are not deductible. These expenses would be the fees to the surrogacy foundation, any legal fees relating to the parenting agreement, travel to the foundation or to meet with the surrogate mother , the costs of medical testing prior to conception, and the invitro fertilization procedure.

Utah law does allow a deduction for living expenses paid to the birth mother as long as they are in conformance with Utah Code Sec. 76-7-203. It is unclear exactly how much was paid to the birth mother and whether the amount would conform with that section. In addition only the actual travel costs incurred exclusively for the purpose of completing the adoption arrangements are deductible. Travel to be present for the ultrasound or any other reason is not deductible.

As Respondent has indicated Petitioners have the burden of proof in this matter and it would be up to Petitioners to provide support and evidence of the amounts paid for the allowable medical expenses and adoption expenses in conformance with this decision.

DECISION AND ORDER

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Based on the foregoing, the Tax Commission sustains the assessment of additional income tax and interest against Petitioner for the tax year 2001. It is so ordered. However, the Commission would encourage the parties to work together to determine the amount that would be deductible in conformance with this decision. If the parties are not able to reach an agreement on the amount within thirty-days, Petitioners may want to consider protecting their appeal rights by requesting a Formal Hearing as outlined below.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a request shall be mailed to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission  
Appeals Division  
210 North 1950 West  
Salt Lake City, Utah 84134

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this \_\_\_\_\_ day of \_\_\_\_\_, 2005.

\_\_\_\_\_  
Jane Phan

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Administrative Law Judge

BY ORDER OF THE UTAH STATE TAX COMMISSION.

The Commission has reviewed this case and the undersigned concur in this decision.

DATED this \_\_\_\_\_ day of \_\_\_\_\_, 2005.

Pam Hendrickson  
Commission Chair

R. Bruce Johnson  
Commissioner

Palmer DePaulis  
Commissioner

Marc B. Johnson  
Commissioner

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