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White Paper

Tax Credits

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Tax Credits

What are tax credits?

A tax credit is a dollar-for-dollar reduction of your tax liability. After you've calculated your federal taxable income and computed the tax on it, you can subtract any income tax credits that may apply to arrive at the amount of tax you must pay or the refund you'll receive.

What's the difference between a tax credit and a tax deduction?

A tax deduction reduces the income on which your taxes are calculated, and so only reduces your tax liability on a percentage basis (as determined by your marginal income tax rate). By contrast, a tax credit reduces your actual tax liability on a dollar-for-dollar basis.

For instance, if you're in the 28 percent marginal income tax bracket, a deduction of \$100 will save you \$28. But a tax credit of \$100 will save you \$100 regardless of your tax bracket.

What types of federal income tax credits are available?

The three main categories of tax credits are:

- The personal refundable and nonrefundable tax credits
- The business incentive tax credits
- The foreign tax credit

Personal refundable credits

If a personal refundable tax credit is greater than the amount of your tax liability, you can obtain an income tax refund. Examples of such refundable tax credits include:

- The refundable portion of the child tax credit ("additional child tax credit")
- The earned income credit
- Payments of estimated taxes
- Excess Social Security tax withheld
- Tax withheld from salaries and wages

Tip: The Housing and Economic Recovery Act of 2008 created the first-time homebuyer credit, which is a temporary refundable tax credit equal to 10 percent of the purchase price of a home, up to \$7,500 (\$3,750 if married filing separately). However, this credit is actually an interest-free loan. Two years after you claim this credit, you must start paying it back. The payback can be made over 15 years in equal installments. So, if you claim a \$7,500 credit on your 2008 tax return, you would start paying \$500 a year back with your 2010 return. If you sell the home during the 15-year period,

then the remaining credit amount would be due from the profit on the home sale. If there is insufficient profit, then the remaining credit payback will be forgiven. Also, if you die during the 15-year period, the balance will be forgiven. The credit starts phasing out for taxpayers with \$75,000 of modified adjusted gross income (MAGI) (\$150,000 if married filing jointly). The credit is completely phased out for taxpayers with \$95,000 MAGI (\$170,000 if married filing jointly). The qualifying home must be purchased on or after April 9, 2008 and before July 1, 2009, and eligible taxpayers must claim the credit on their 2008 or 2009 tax return.

Personal nonrefundable credits

Personal nonrefundable tax credits may reduce your tax liability, but not below zero. For tax years 2008 and thereafter, all personal nonrefundable tax credits (other than the adoption credit, the child tax credit, and the tax credit for IRAs and retirement plans) are allowable only to the extent that regular income tax exceeds the tentative minimum tax--part of the AMT calculation.

There are several personal nonrefundable credits, including the following:

- The adoption tax credit
- The child and dependent care credit
- The tax credit for the elderly or the disabled
- The credit for qualified electric vehicles
- The credit for qualified alternative fuel (or clean-fuel) vehicles
- Tax credits for energy-saving home improvements
- The Hope credit
- The Lifetime Learning credit
- The tax credit for IRAs and retirement plans
- The child tax credit (nonrefundable portion)

Business incentive tax credits

The business incentive tax credits are designed to encourage certain economic activities, such as investment in disadvantaged communities. These business-related credits are combined into one "general business tax credit."

The foreign tax credit

Both business and individual taxpayers who qualify may take the foreign tax credit. Although this tax credit is nonrefundable, any foreign tax credit not used in the current tax year can be carried back for two years and carried forward for five years.

Summary of the specific credits

Child tax credit

The child tax credit provides a tax credit of \$1,000 per qualifying child in tax years 2003 through 2010. The credit is phased out for taxpayers with modified adjusted gross income (AGI) above certain levels. A portion of this credit may be refundable for certain taxpayers on IRS Form 8812, and special rules may apply for taxpayers with three or more qualifying children. Child Tax Credit provides an in-depth discussion of this credit.

Earned income credit

The earned income credit is available to certain low-income working taxpayers who have earned income and who receive no more than a specified amount of investment income during the year. Eligibility for this credit depends on several factors, including the number of qualified children you have (if any), your filing status, and the amount of your AGI.

Adoption tax credit

You may take a tax credit for your qualified expenses incurred in adopting an eligible child. In addition, you can exclude from your income certain adoption expenses paid or reimbursed by your employer under a qualified adoption assistance program.

In 2008, the maximum credit and exclusion amount is \$11,650 (\$11,390 in 2007) per child. Both the credit and the exclusion are partially phased out if your AGI exceeds \$174,730 (\$170,820 in 2007), and completely eliminated when your AGI reaches \$214,730 (\$210,820 in 2007).

If the amount of your credit is greater than your current year's tax liability, any unused credit can be carried forward for up to five years.

You must file Form 8839 to claim the adoption credit.

Child and dependent care credit

You may be able to take this credit if, in order to work, you pay someone to care for your child who is under age 13, your qualified disabled dependent, or your disabled spouse. Several requirements and restrictions apply. You use Form 2441 to calculate the amount of this credit.

Caution: You generally can't claim this credit unless you report the correct name, address, and taxpayer identification number of the dependent care provider. The taxpayer identification number requirement is waived in the cases of certain tax-exempt providers.

Tax credit for the elderly or the disabled

To claim this credit, you or your spouse must be either of the following by the end of the year:

- Age 65 or older, or
- Under age 65, retired on permanent and total disability (a disability that is expected to last indefinitely, rendering the wage earner unable to work), and the recipient of taxable disability income during the year

In addition, your AGI as well as your total nontaxable Social Security and other nontaxable pension income must fall below certain limits.

Credit for qualified alternative fuel (or clean-fuel) vehicles

The Energy Tax Incentives Act of 2005 created this tax credit, which is actually a combination of four credits: (1) the hybrid vehicle credit, (2) the advanced lean-burn technology vehicle credit, (3) the alternative fuel vehicle credit, and (4) the credit for vehicles powered by fuel cells. The maximum credit for a hybrid or advanced lean-burn technology passenger vehicle or light truck is \$3,400, and is available in 2006 through 2010. The maximum credit for alternative fuel passenger vehicles and light trucks is \$4,000, and is available in 2006 through 2010. The maximum credit for fuel cell passenger vehicles and light trucks is \$12,000, and is available in 2006 through 2014. The credit for hybrid vehicles replaces the deduction for hybrid vehicles in 2006.

Tax credits for energy-saving home improvements

The Energy Tax Incentives Act of 2005 created two new tax credits for making certain energy-saving home improvements. The residential energy conservation property credit is a \$500 maximum lifetime credit for making energy-efficient improvements or installing energy-efficient property to your home. The residential energy-efficient property credit is a 30 percent credit, up to a maximum of \$2,000 for any tax year, to help offset the costs of installing solar hot water or electricity-generating solar (photovoltaic) systems in a home. The credit also applies to the installation of fuel-cell property, but is limited to \$500 per .5 kilowatt hour of capacity. These credits are available in 2006 and 2007.

Hope credit

The Hope credit is for taxpayers who pay certain higher education costs. It's available for qualified higher education expenses that you (or your spouse or dependent) incur at an eligible educational institution. The maximum tax credit is generally \$1,800 (2008 figure; \$1,650 for 2007) per student per year for qualified tuition and related expenses incurred during the first two years of post-secondary education. The amount of your credit (if any) depends on the level of your AGI. To qualify for this credit, you must meet several requirements.

Lifetime Learning credit

The Lifetime Learning credit is generally worth up to \$2,000 per year for qualified tuition and related expenses incurred for course work at eligible educational institutions. The credit is not limited to the first two years of post-secondary education, and you may enroll as less than a half-time student and still qualify. The credit is also available for graduate and professional-level courses.

Tax credit for IRAs and retirement plans

The tax credit for IRAs and retirement plans was designed to encourage certain low- and middle-income taxpayers to save for retirement. Qualifying taxpayers may claim a nonrefundable income tax credit for contributing to certain tax-deferred retirement savings vehicles, such as IRAs, 401(k) plans, and others. If you're eligible, the amount of your credit (if any) will depend on your AGI, your filing status, and the amount of your IRA and retirement plan contributions for the year.

General business tax credit

The general business tax credit is comprised of a series of credits that businesses can claim. These credits, listed on Form 3800, include the following:

- Disabled access credit
- Empowerment zone employment credit
- Renewal community employment credit
- New markets credit
- Indian employment credit
- Work opportunity credit
- Welfare-to-work credit
- Low-income housing credit
- Small employer pension plan startup credit
- Credit for employer-provided child care
- Investment tax credit
- Credit for employer-paid FICA tax on employee tips
- Research expense credit
- Community development corporation credit
- Renewable electricity production credit
- Alcohol fuels credit
- Enhanced oil recovery credit
- Orphan drug credit
- Credit for Trans-Alaska Pipeline Liability Fund
- Nuclear power reduction credit
- Alternative fuel (or clean-fuel) vehicle credit
- Clean-fuel refueling property credit
- Energy-efficient new home construction credit
- Energy-efficient home appliance credit
- Small agri-biodiesel fuel producer credit
- Indian coal credit
- Fuel cell and micro-turbine power plant credit
- Agricultural chemicals securities credit
- Differential wage payment credit

The amount of the general business credit cannot exceed your net income tax reduced by the greater of:

- The tentative minimum tax, or
- Twenty-five percent of the excess of your net income tax over \$25,000

If this limitation prevents you from claiming your full general business credit, you can carry back and then carry forward unused credits.

Tip: Under the Housing and Economic Recovery Act of 2008, the low-income housing credit and the rehabilitation credit can be used to offset AMT to the extent that the credits are attributable to expenditures properly taken into account for periods after December 31, 2007.

Foreign tax credit

If you pay income taxes to both the United States and a foreign government on the same income, you may choose on your U.S. federal income tax return between claiming a deduction or a tax credit for the foreign income taxes you paid. In most cases, it is more advantageous to take the credit. The credit applies to income taxes you pay to a U.S. possession, a foreign country, or to any province, state, city, or other subunit of a foreign country.

Refundable credit for health insurance costs of qualifying individuals

The Trade Act of 2002 (H.R. 3009) created a refundable credit for specific health insurance costs of individuals who lost their jobs due to trade-related reasons (as determined by the U.S. Department of Labor and state labor agencies) and who qualify for trade adjustment assistance. The tax credit also applies to eligible uninsured recipients of Pension Benefit Guaranty Corporation (PBGC) benefits who are between the ages of 55 and 64.

The tax credit available is equal to 65 percent of qualifying health insurance costs. Qualifying health insurance costs include the cost of COBRA coverage, certain state programs, and, in limited cases, coverage under an individual insurance policy or a spouse's group health plan. Availability of the credit is determined on a monthly basis. Consult a tax professional for additional information.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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