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INDIVIDUAL TAX & FINANCIAL PLANNING NEWSLETTER

Welcome to the "Newsletters" section of my website. It is here that I hope to inform and educate about all things tax. If you have any comments or suggestions for topics I might deal with, please send an e-mail to Charles@Slatercpa.com. Also, if you would like to have these newsletters delivered to your in box by e-mail, please sign up here.

Tax Credits vs. Deductions

In previous newsletters I have dealt with the issue of tax credits. In talking with people, however, it has occurred to me that many people tend to confuse tax credits and tax deductions. The following discussion is intended to shed some light on the difference between the two.

A deduction is, as the name implies, simply an amount subtracted from total income in order to calculate taxable income. Certain expenses are deducted from income in order to arrive at taxable income. The simple example below illustrates the role of deductions in the calculation of tax:

$1000 Income
-500 (Deductions)
$500 Taxable Income
X 10% Tax Rate
$50 Tax Liability

An important thing to consider is the relationship of deductions to tax liability. Let us say that the amount of deductions in the above example were to increase by $100. What would be the effect on tax?

$1000	Income
-600	(Deductions)
$400	Taxable Income
X 10%	Tax Rate
$40	Tax Liability

It can be easily seen that a $100 increase in deductions resulted in a $10 decrease in tax.

A credit, on the other hand, directly acts upon the tax liability, reducing what the taxpayer must pay. Let's continue the above example by assuming that, instead of $100 increase in deductions, the taxpayer qualified for a $15 credit on his tax liability:

$1000	Income
-500	(Deductions)
$500	Taxable Income
X 10%	Tax Rate
$50	Tax Liability
-15	Less Tax Credit
$35	Net Tax Due

The $15 tax credit reduced his taxes by $15. Whereas a $100 tax deduction would reduce the tax due by only $10. On the face of it, a $100 deduction sounds better than a $15 tax credit. But, as we have seen, tax credits usually provide more bang for the buck.

A Selection of Available Tax Credits

Congress has used tax credits as a way of getting more money to certain taxpayers, or to encourage certain behaviors. The list of available tax credits is very lengthy. Below is a list of several tax credits available to individuals along with a brief description of each.

- Earned income Credit - This is a credit that is targeted at low-income taxpayers. It is calculated according to a sliding scale that is based on income. It is called a refundable credit because, under certain circumstances, a taxpayer can receive a refund that is greater than what has been withheld.
- Foreign Tax Credit – Since U.S. citizens are taxed on their world wide income, a credit exists for taxes that have been paid on foreign source income. Most taxpayers encounter this through investment in global or international mutual funds. These funds invest in international stocks whose dividends are taxed by

foreign governments. The shareholder's share of these taxes are shown on brokerage statements. They can thus take a credit on their tax return for having paid tax on that income.

- Adoption Credit – This is a substantial tax credit available to taxpayers who adopt a child. To get the credit, the taxpayer must have incurred eligible expenses in a qualified adoption. The credit is for up to $11,650 in adoption expenses for 2008, though this amount is phased out for higher income taxpayers.
- Child & Dependent Care Credit – This is a credit for taxpayers who work and at the same time incur expenses related to the care of a child under 13, a spouse, or another dependent. It is even available for certain taxpayers who are looking for work or who are going to school full time. The credit is calculated by multiplying expenses for dependent care by a sliding percentage. This sliding percentage gives more credit to lower income workers.
- Mortgage Interest Credit – This is a credit that is available to lower income taxpayers who own their homes. It works like a rebate of some of the interest paid on a qualified home mortgage.
- Credit for elderly and/or permanently disabled – This is a credit of 15% of the income of taxpayers over 65, or who are permanently disabled. Income, in this case, does not include Social Security or any pension or annuity payments. The credit also phases out at a fairly low level of income.
- Child tax credit – This is one of the simpler credits. It is a credit of $1,000 for family's who have dependent children less than 17 years old. It is subject to a phase out for higher income taxpayers.
- Credit for Retirement Savings – This is a credit for eligible individuals who contribute to a retirement savings plan. The credit is a percentage of the contributions, which are capped at $2000. The percentage is a sliding scale based on income which reduces for higher incomes. No credit is available above certain levels of income.
- First-time Homebuyer Credit – This is a new credit, beginning in 2008. A first-time homebuyer is one who had no ownership of a principal residence during the 3 year period prior to the purchase. The home purchase must be between April 9, 2008 and July 1, 2009. It is possible to elect to take the credit on the 2008 return if the purchase is made before July 1, 2009. The credit is equal to 10% of the purchase price up to $7,500 and is refundable. This does phase out for higher income taxpayers. Unfortunately, the credit is to be recaptured, (paid back), over a 15 year period. Because of this provision, it is really in effect a 15 year no-interest loan from the government.

- Energy Efficient Home Credit – A 10% credit on the cost of energy efficiency improvements such as insulations, windows and doors. The credit has a lifetime limit of $500. This credit is not available for 2008 returns but will come back again in 2009.

- Residential Energy Efficient Property Credit – A 30% credit on the cost of solar electric generating, water heating, or fuel cell electric generating equipment. There is a maximum credit allowed per year of $2000 for solar generating, $2000 for solar heating, and $500 per ½ Kilowatt of fuel cell generating. This credit has been extended through 2016.

If you have questions about these or would like to see if any of these apply to your situation, please send me an e-mail.

Sale of Personal Residence

The sale of a principal residence is something that most people face from time to time. Such a sale normally results in a capital gain, particularly if the owners have been in the house for some time. However, the tax laws allow most, if not all, of the gain to be excluded if certain requirements are met. In order to understand how this works, we will have to define a few terms.

- Residence: A dwelling that has eating, sleeping, and bathroom facilities. This could include a house, mobile home, motor home, houseboat, etc. The taxpayer must have legal ownership.
- <u>Principal</u> residence: A residence that is designated by the taxpayer as his/her principal residence. Individuals can have only one principal residence at a time. Outside evidence to support the designation of a principal residence include things like the time spent at the residence, location of employment, driver's license information and voting registration.
- Basis: The taxpayer's investment in the property. This is normally the cost of the property plus any additions or improvements.
- Selling Price: The total sales price for the residence less any selling costs.
- Gain or Loss: The difference between the selling price of the property and the owner's basis. A positive difference is a gain while a negative difference results in a loss.

Example: Let's say the Jones' are selling their residence of 30 years. It was purchased in 1969 for $30,000. They added a bedroom in 1988 at a cost of $25,000. It is now selling in 2009 for $210,000. The Jones' gain on this transaction is calculated below:

Selling Price	$210,000
Basis (30,000 + 25,000)	$55,000
Gain	$155,000

They potentially have a capital gain on this transaction of $155,000. At current capital gain rates this could amount to some $23,000 in tax. However, Congress has provided an out in the Sec. 121 exclusion of the gain. If the Jones' file a joint return and meet certain other requirements, they can exclude, (forget about), up to $500,000 of gain. Thus, they can walk away from the sale with their entire $210,000 sales price and pay absolutely no tax.

As I said, there are a few restrictions placed on this exclusion:

1. The taxpayer must have owned the residence for at least two out of the five years preceding the sale.
2. The residence must have been the taxpayer's principal residence in at least two out of the five years prior to the sale.
3. The taxpayer can only use this exclusion once every two years. Another way of saying this is that the taxpayer cannot have excluded the gain or the sale of another principal residence within two years prior to the sale.

These are the basic rules of the Section 121 gain exclusion. There are other rules that deal with exceptional circumstances; i.e. job loss, death, separate returns, etc. But, on the whole, this is the situation.

The rules give us some planning opportunities, particularly in regard to second or vacation homes. If you are interested in discussing how this relates to your particular situation, please get in contact with me.

Economic Stimulus Payment

The economic stimulus of 2008 is now history in the sense that no more cash payments are being sent out by the government. However, there is a second chance available for those who qualify but did not receive cash in 2008.

The economic stimulus was really a rebate of 2008 taxes, but it was paid early and initially based on the filer's 2007 tax return. There is a new line on the 2008 form 1040 that provides a credit on 2008 taxes. You will not receive the check; you will receive a credit on the 2008 tax return. This will add to your refund, or reduce the amount due by the amount of the stimulus.

Some confusion and misunderstandings will inevitably result from the government doing this is in a back-door manner. All that can be done is to prepare the 1040 as accurately as possible, which means we have to know if you received your check or not. Be sure to indicate in any correspondence whether or not you received a stimulus rebate check in 2008. That will go a long way towards cutting down unnecessary correspondence with the IRS.

Charles Slater, CPA is an accounting and consulting firm that seeks to offer the highest level of service to its clients. The firm has particular expertise in assisting the small business owner in managing their business. The firm also offers services in the areas of tax, payroll, accounting and bookkeeping, and financial statement compilation. For further information, please contact:

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