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TAX AND BUSINESS ADVISOR

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Residential Energy Credit

One way to control the cost of home energy use is to make your home more energy efficient. Better still when those energy-saving improvements qualify for a federal tax credit. Fortunately, individual taxpayers are allowed a personal tax credit for energy-efficient improvements to their principal residence. The Nonbusiness Energy Property Credit (Residential Energy Credit) has been available since 2006, but the recently passed American Recovery and Reinvestment Act of 2009 (Stimulus Act) substantially increased this credit available for energy-efficient home improvements.

Under pre-Stimulus Act law, an individual taxpayer's Residential Energy Credit equaled the sum of (a) 10% of the amount paid for qualified energy-efficiency improvements (i.e., building envelope components meeting certain requirements) installed during the tax year, and (b) the amount of any residential energy property expenditures (i.e., $50 for each advanced main air circulating fan; $150 for each qualified natural gas, propane, or oil furnace or hot water boiler; and $300 for qualified energy-efficient property, including heat pumps, water heaters, and central air conditioners) paid during the tax year. The Residential Energy Credit was also subject to a lifetime cap of $500 for all tax years (no more than $200 of which could be for windows).

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The Stimulus Act modified the Residential Energy Credit by increasing the 10% rate to 30%. In addition, the dollar limitations on residential energy property expenditures have been eliminated; instead, all energy property that was previously eligible for the $50, $150, and $300 credits is eligible for the 30% credit. Also, with the Stimulus Act, the $500 lifetime cap ($200 for windows) is eliminated and replaced with an *aggregate* $1,500 cap for 2009 and 2010. Finally, the Residential Energy Credit was originally set to expire at the end of 2009, but the Stimulus Act extends the credit through Dec. 31, 2010.

Most of us are prone to complain about the cost of energy and the amount of taxes we pay. The Residential Energy Credit gives us a way to save on energy costs and taxes.

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Annual Gift Tax Exclusion

The Annual Gift Tax Exclusion provides a tax-advantaged way to reduce your taxable estate and make generous gifts, as well. The exclusion allows any individual to gift property valued at $13,000 (in 2009, indexed for inflation) or less without having to file a gift tax return or reduce their $1 million lifetime Gift Tax Exclusion. The annual exclusion applies on a per-donee basis, and there is no limit to the number of donees to which gifts subject to the annual exclusion can be made.

The purpose of the annual exclusion is to allow taxpayers relief from reporting numerous small gifts. The $13,000 amount was intended to be large enough to cover wedding, holiday, birthday, and other occasional gifts. However, many taxpayers fail to take these occasional gifts into consideration when making $13,000 gifts intended to take advantage of the annual exclusion. Taxpayers who undertake a gifting program should be aware that the $13,000 annual exclusion amount includes all gifts made to the donee for the year.

Adoption Credit

Taxpayers can claim a tax credit for certain eligible adoption expenses or exclude from income employer-provided adoption assistance if their employer maintains an adoption assistance program. The credit and exclusion are subject to a dollar limitation and phase-out for taxpayers whose income exceeds certain thresholds.

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For 2009, taxpayers can claim a credit for up to $12,150 of qualifying adoption expenses. This is not an annual limitation; instead, it applies to the adoption of each child and is cumulative (for that child) over all tax years. When applying the limitation, adoption expenses incurred in an unsuccessful attempt to adopt an eligible child are included with those of the first subsequent successful adoption. The limitation is the same for both married and unmarried taxpayers, but married couples must file a joint return to claim the credit.

The credit for an adoption involving a child with special needs that becomes final in the tax year is automatically $12,150, regardless of the actual amount (even if less than $12,150) of qualifying adoption expenses incurred.

Excluding Unemployment Compensation from Taxation

Prior to the American Recovery and Reinvestment Act of 2009 (Stimulus Act), any unemployment compensation received was reportable as taxable income by the recipient. So, even though unemployed, the taxpayer was required to pay federal income tax on his or her benefits.

The Stimulus Act changed this provision for amounts received in 2009. This year, up to $2,400 of unemployment compensation can be excluded from taxable income by the recipient. This valuable exclusion should help numerous taxpayers, particularly during the current economic downturn.

Deducting Fraudulent Investment Scheme Losses

In spite of diligent efforts by regulatory organizations to prevent fraudulent investment schemes, unscrupulous individuals and firms continue to find ways to manipulate the system and defraud unwary investors. Recent high profile multibillion-dollar investment schemes (e.g., Ponzi-type schemes) have cost numerous investors their life savings. In a Ponzi-type scheme, for example, investment managers purportedly invest cash on behalf of each investor in an account with the investor's name. The investment manager then reports fictitious investment transactions and earnings to the unsuspecting investor. The investment manager uses some funds from new investors to meet principal and earnings withdrawal requests from prior investors. However, a large percentage of the investor's funds are generally stolen by the investment manager for personal use.

Most of the funds invested in these schemes will never be recovered, but recent tax guidance provides a theft loss deduction for (a) the initial and subsequent investments, less withdrawals and (b) any previously reported income that was never actually received. Hopefully, this taxpayer-friendly provision will provide some monetary relief to those who were victimized. The theft loss deduction is available for the taxable year in which the loss is discovered. However, if there is a possibility a portion of the loss will be recovered, that portion is not considered a theft loss until a final determination is made.

Example: Fraudulent investment scheme loss.

Larry invested $200,000 with High Yield Investment Advisors (High Yield) eight years ago. He was so satisfied with the average annual return that he invested an additional $100,000 with High Yield five years ago. Larry also reinvested his earnings of $162,000 (over seven years) and included the appropriate amount in his taxable income each year. In year seven, he withdrew $50,000 to purchase a new car.

In year eight (2009), Larry was notified that he had been the victim of a Ponzi-type scheme. Larry was informed that most of his investment and reinvested earnings will never be recovered. However, the liquidation of High Yield's remaining assets should eventually lead to an approximate $35,000 recovery for Larry. As a result of the theft by High Yield, Larry can claim a theft loss of $377,000. His theft loss is comprised of his initial and subsequent investments totaling $300,000 ($200,000 + $100,000); plus the $162,000 reinvested earnings; less his $50,000 withdrawal and $35,000 potential recovery.

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So, Larry will be able to deduct $377,000 as a theft loss on his 2009 federal tax return.

Whether and when an investor meets the requirements for claiming a theft loss resulting from a fraudulent investment scheme are highly factual determinations. In view of the number of investment arrangements recently discovered to be fraudulent and the extent of the potential losses, an optional *safe harbor* is available whereby an investor (subject to qualifying characteristics) may treat a loss as a theft loss deduction when certain conditions are met. The safe harbor allows up to 95% of qualified losses, calculated through detailed definitions and formulas, to be deducted as a theft loss. This treatment provides qualified investors with a uniform manner for determining their theft losses and avoids the difficult task of proving how much income reported in prior years was fictitious earnings or simply a return of capital.

If you have been victimized in a fraudulent investment scheme, please contact us to determine the best course of action.

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Corporate Governance and the Board of Directors

In recent years, the term corporate governance has become widely used in news publications and broadcasts, thus bringing to the forefront a public awareness of general corporate responsibility and accountability. Corporate governance can be defined as the oversight management of a company's financial activities, including all financial reporting matters, tax compliance, and executive compensation issues. Preserving the longevity of the corporation, criminal fraud prevention, fraud detection, and corporate accountability are expectations and responsibilities of sound corporate governance.

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The demise of several public companies has been blamed, at least in part, on corporate governance failures. The proper operation of such oversight could have provided early detection of the unchecked fraudulent behavior and lack of transparent disclosure and controls that contributed to the downfall of those entities. Ultimately, the board of directors has the primary responsibility for such oversight. However, this responsibility is shared by executive management because of its direct involvement, knowledge, and approval of corporate financial activities.

While the concept of corporate governance has been introduced at the large public company level, its applicability to the closely held corporation should not be ignored. Regardless of size, the closely held corporation faces issues similar to those of the large public entity, which are to sustain profitability, grow the company, and maintain transparent ethical financial practices. Furthermore, effective corporate governance in the closely held corporation should help to shield the assets of its owners from loss due to fraud, poor planning, and litigation originating from, or lost due to, inadequate corporate governance.

A key to successful corporate governance is an effective board of directors. To be effective, the board must have qualified members and, in the case of a closely held corporation, a collaborative relationship with the entity's owners, measurable goals, and a process of evaluating its performance.

Acquiring qualified board members can be a challenge, especially given the risk each member takes and that compensation can be low or nonexistent. When resources for a board member search are limited, good candidates can be selected from current legal advisers, corporate bankers, and the business owners of suppliers or customer businesses.

Board members can be protected from personal liability for legal costs or claims through an indemnification from the corporation and through directors and officers insurance.

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