

2004 tax year in perspective

Two recent pieces of tax legislation may affect your tax situation this year: the *Working Families Tax Relief Act of 2004* (Families Act), which extends marriage penalty relief and several business tax credits and other provisions, and the *American Jobs Creation Act of 2004* (Jobs Act).

The Jobs Act, signed into law October 22, 2004, is the major tax event of the year and the most significant tax legislation affecting businesses in two decades.

The Jobs Act enjoyed biparti-

san support and is estimated to be revenue neutral. It will affect almost every business, but manufacturers and contractors will especially benefit.

In addition, it has various effective dates for different provisions, including some retroactive. Accordingly, taxpayers, especially businesses, should take immediate steps to evaluate its impact.

Meanwhile, the Internal Revenue Service (IRS) is shifting its emphasis from customer service and is allocating more resources and energy to enforcement initia-

tives. This is due in large part to recent scandals involving abusive tax shelters.

No one can predict the future, but if previous presidential elections are any indication, 2005 may bring another year of meaningful tax legislation.

This issue of the *Advisor* covers year-end tax planning for individuals and businesses, plus other notable strategies and topics.

Many of the tax-planning strategies you find in this issue must be implemented in 2004 to be effective. □

Inside

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Two acts bring relief to taxpayers

The *American Jobs Creation Act of 2004* (Jobs Act) and the *Working Families Tax Relief Act of 2004* (Families Act) were both enacted in October.

The Jobs Act began as a bill to repeal a tax break for U.S. exporters, a break the World Trade Organization (WTO) considered an illegal export subsidy.

The Jobs Act will affect almost every business and contains provisions that also affect individual taxpayers. It is the fifth major tax act in four years and adds additional complexity to tax law. Various provisions have various effective dates, and many provisions require immediate action.

The Families Act is much smaller in scale and extends tax breaks set to expire, including mar-

riage penalty relief and business tax credits.

Both acts create planning opportunities and challenges for taxpayers that can be found in **2004 Tax Law Highlights**, a booklet available at www.bkd.com that summarizes the more significant provisions of each act and breaks them into individual and business tax provision sections.

We look forward to answering your questions about how each act affects you and to helping you identify how to take advantage of their provisions. □

See pages 2 - 4 for...



Overview of 2004 tax legislation



A Special Year-end Planning Issue

Overview of 2004 American Jobs

The *American Jobs Creation Act of 2004* (Jobs Act), signed into law October 22, replaces the exclusion for extraterritorial income (ETI exclusion) and provides tax breaks for manufacturers, producers and other businesses.

Following are major provisions that have the broadest application; related year-end tax planning strategies appear in bold type.

Repeal of ETI exclusion -

The ETI exclusion provides a deduction for products manufactured in the U.S. that are exported. The WTO has imposed sanctions penalties on U.S. exports because it ruled the ETI is an illegal export subsidy.

In response, the ETI exclusion will be phased out gradually until its full repeal in 2007; however, the exclusion will continue to apply to qualifying binding contracts in effect on September 17, 2003.

Affected taxpayers should consider accelerating income into

Some of the information in this Advisor is specific to 2004 and may not be relevant after December 31, 2004. As always, talk with your BKD advisor before taking any action.

Contact your BKD advisor to schedule a presentation on "2004 Tax Law Summary" for members of your community, business, civic or charitable organizations.

Provisions crack down on certain charitable gifts

by Joyce Dulworth, Fort Wayne,
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Charitable gifts, such as patents and vehicles, have come under close scrutiny in recent years. The Jobs Act contains several key provisions affecting charitable organizations and their donors.

Noncash gifts are typically valued by the donor using a fair market value standard, such as publicly traded securities that can be easily valued based on published market prices.

Other noncash gifts can be much more difficult to value and often require an appraisal. Recent concern of perceived abuses in this area caused limitations to be enacted.

For donations of patents after June 3, 2004, the initial charitable deduction will be the lesser of the taxpayer's basis or the fair market value of the property.

Since the taxpayer's basis is often very low, the initial deduction also will be low. The charity can then license the patent and produce qualified donee income.

For the 10 years subsequent to the donation, the donor will get a deduction for a portion of the income the charity receives on the patent. Charities will be required to report this income to both the donor and the IRS.

After December 31, 2004, the deduction for vehicle gifts will be limited. Consider donating an automobile in 2004, before the new restrictions kick in.

Under the new rules, if a charity sells a donated automobile within 30 days, the donor will receive a tax deduction based on the actual sales price. If the vehicle is used by the charity for more than 30 days, the charity will be required to provide certification of its use. □

2004 and deferring expenses to 2005.

The WTO has announced it will lift the sanctions, but certain grandfathering provisions may result in future sanctions.

Deduction for qualified production activities -

For tax years beginning in 2005 and thereafter, the Jobs Act provides a deduction for qualifying manufacturing/production activities undertaken in the U.S. equal to the lesser of qualified production activities income or taxable income multiplied by 3% for 2005 and 2006, 6% for 2007-2009, and 9% thereafter.

The deduction is limited to half the business's total W-2 wages for the year and is available to cor-

porations, partnerships, sole proprietorships and other taxpayers, regardless of whether the products are exported. The deduction generally applies to:

- ✓ Manufacturing
- ✓ Construction, including architecture/engineering
- ✓ Energy production
- ✓ Computer software production
- ✓ Film and video production
- ✓ Agricultural production
- ✓ Equipment leasing

For this purpose, production is broadly defined but does not apply to restaurants or the transmission or distribution of electricity and oil and gas.

Affected taxpayers should

plan now to capture direct and indirect expenses to calculate qualified production activities income for 2005.

Businesses that do not currently pay W-2 wages should consider doing so in 2005 to take advantage of the deduction. This includes a sole proprietor who legitimately employs a spouse. The IRS is scheduled to release further guidance on this deduction.

Stock options - Under the Jobs Act, neither the exercise of statutory stock options, nor the transfer of stock under an employee stock purchase plan will result in FICA and FUTA taxes, making such compensation plans more attractive to employers and employees.

tax legislation

Creation Act of 2004

SUV expensing limits - For passenger SUVs placed into service after October 22, 2004, the "Section 179" expense deduction is limited to \$25,000 (instead of \$102,000).

However, first-year 50% bonus depreciation is still available for SUVs until December 31, 2004 (see example below).

Example

A new \$45,000 SUV used 100% for business purchased in 2004 after the Jobs Act enactment can result in a deduction of:

\$25,000	Sec. 179 Expense
10,000	Bonus Depreciation
+ 2,000	Regular Depreciation
\$37,000	

Enhanced Section 179 amounts extended - Section 179 provides a first-year depreciation write-off for qualified business assets and also applies to qualified software purchases.

The Jobs Act extends the increased deduction for qualifying business assets (but not SUVs), resulting in a maximum Section 179 deduction of \$102,000 through 2007 and \$25,000 in years thereafter. These amounts will be adjusted annually for inflation.

Nonqualified deferred compensation plans - In general, all compensation (current and prior deferrals) deferred under a nonqualified deferred compensation plan will be taxable to participants to the extent compensation is not subject to a substantial risk of forfeiture, unless new distribu-

tion, benefit acceleration and election requirements are met.

The new rules place significant restrictions on such plans. All nonqualified deferred compensation plans will need to be modified and re-evaluated.

The new rules not only apply to compensation deferred after 2004 but also to plans that are materially modified after October 3, 2004.

Accordingly, existing plans should not be modified in 2004 without first considering the new rules.

50% bonus depreciation extension for noncommercial aircraft - While the bonus depreciation expires after 2004, qualifying noncommercial business aircraft placed in service before 2006 will be eligible for the bonus depreciation.

Itemized deduction for sales taxes - For years after 2003 and before 2006, the Jobs Act allows individual taxpayers to elect to deduct sales taxes instead of state and local income taxes as an itemized deduction.

For this purpose, you can use either actual amounts or IRS-published tables. **This is especially important for taxpayers who live in a state with no personal income tax:** Alaska, Florida, Nevada, South Dakota, Tennessee, Texas, Washington and Wyoming. **Your sales tax may exceed your state income taxes if you made major purchases of personal property and paid little income tax.**

S corporation relief - The Jobs Act includes several provisions that liberalize S corporation eligibility requirements. Most no-

tably, the maximum number of eligible shareholders will increase to 100. Family members can elect to be counted as a single shareholder.

Foreign tax provisions - The Jobs Act includes various foreign tax provisions, including reduction of the number of foreign tax credit (FTC) "baskets" from nine to two beginning in 2007, as well as other FTC simplification measures.

It also encourages companies to reinvest foreign earnings in the U.S. and discourages businesses and individuals from expatriating to avoid U.S. taxes. □

(Overview continued on page 4)

New repatriation incentives

by Bill Leary, Houston, bleary@bkd.com

Many taxpayers with foreign operations will see big benefits from the Jobs Act, despite the repeal of the ETI export incentives.

One international tax provision will make dividends from controlled foreign corporations eligible for an 85% dividend received deduction (DRD).

It will be a one-time opportunity and almost every U.S. corporation with foreign subsidiaries will need to consider the potential tax savings available.

The DRD will be available on an elective basis for dividends received either during the taxpayer's first taxable year beginning on or after the date of enactment or during the last taxable year begin-

ning before the date of enactment of the new law.

The deduction will apply only to actual cash dividends not financed by related-party debt; no foreign tax credit (or deduction) will be allowed for foreign taxes attributable to the dividend deduction. Expenses allocated or apportioned to the deduction also are disallowed.

A number of limitations apply to the DRD. First, eligible dividends must exceed dividends recognized during a five-year base period ending June 30, 2003.

Second, eligible dividends are limited to the greater of (1) \$500 million or (2) certain foreign earnings reported on financial statements.

Finally, dividends must be reinvested in the U.S. BKD's international tax professionals can assist you in this area. □

Individual year-end

Overview of 2004 tax legislation

Working Families Tax Relief Act of 2004

The recently enacted *Working Families Tax Relief Act of 2004* (Families Act) provides a tax-cut package for middle-income families and extends more than 20 expired business-related tax provisions. Some important provisions of the new legislation include:

Child credit - The child credit (\$1,000 per child for 2004) was scheduled to drop to \$700 in 2005 but will remain at \$1,000 through 2010.

Marriage penalty relief - Extended are two provisions that provide a measure of relief from the marriage penalty.

The basic standard deduction for joint filers will remain twice that of single taxpayers, as will the 15% rate bracket, through 2010. Both amounts were scheduled to be reduced at the end of 2005.

10% bracket - The scheduled reduction in the amount of income subject to the 10% tax bracket is repealed, effective through 2010.

AMT relief - Higher AMT exemption amounts set to expire are extended through 2005. In addition, nonrefundable personal credits may offset AMT through 2005 instead of expiring after 2003.

Assistance to low-income military families - Qualifying low-income families with a breadwinner serving in a military combat zone will receive an increase in the child and the earned income credits.

Assistance for teachers - The above-the-line deduction for teachers has been extended for 2004 and 2005, a provision that had expired December 31, 2003.

Business-related tax relief - This provision extends the life of more than 20 expired or expiring business-related tax provisions, including the:

- ✓ Research credit (retroactive)
- ✓ Work opportunity and welfare-to-work credits (retroactive)
- ✓ Enhanced deduction for a corporation's donation of computer equipment to schools
- ✓ Archer medical savings accounts
- ✓ Indian employment tax credit □

Estimate taxable income for 2004

Your eligibility for various deductions, credits and other tax breaks depends on your level of adjusted gross income (AGI).

If your projected AGI for 2004 is too high to qualify for a certain tax break, consider ways to reduce your income before year end, *e.g.*, defer income to 2005, accelerate business deductions, contribute more to your retirement plan or sell investments to generate capital losses.

Gift tax strategies

Take advantage of the annual exclusion for gifts. You can reduce your taxable estate by giving \$11,000 per donee per year without dipping into the lifetime exclusion amount or incurring gift tax.

Other strategies include:

- ✓ When making gifts, give assets expected to increase in value in the future; this will help increase the benefits to your estate
- ✓ Consider a family limited partnership to transfer assets to heirs in a tax-efficient manner while retaining control
- ✓ Pay tuition directly to the educational institution instead of to the student; direct payments are not taxable as gifts (same goes for medical expenses, including insurance premiums)

Trust tax strategies

To avoid the less-favorable trust tax rates:

- ✓ Distribute trust income, as appropriate, to beneficiaries before year end; however, if the beneficiary is subject to the highest marginal tax rate, the trust's lower tax brackets may

be used for tax efficiency

- ✓ Consider electing a fiscal year rather than a calendar year for estates, thereby allowing sufficient time to distribute income to beneficiaries

For income tax purposes, elect to treat a revocable trust owned by a decedent as part of the estate; this allows the trust to elect a fiscal year, take a charitable deduction, deduct up to \$25,000 in passive real estate losses and qualify for the \$600 exemption.

For more information, see page 11, "Is a revocable trust right for you?"

Charitable contributions

When making a charitable contribution:

- ✓ Make sure the charity is qualified; check on its tax status at www.irs.gov (IRS web site)
- ✓ Keep cancelled checks or have a receipt for cash for contributions less than \$250
- ✓ Have a receipt for contributions of \$250 or more
- ✓ Have a qualified appraisal for most property donations that exceed \$5,000

Planning can help make the most of your donations. Donations of personal services, rent-free office space use and interest-free loans are not deductible.

For more information, see page 2, "Provisions crack down on certain charitable gifts."

Dependency Exemption

2004	2005
\$3,100	\$3,200

planning strategies

FICA Tax Schedule

	Rate	2004 Wage Base	2005 Wage Base
Social Security	6.20%	\$87,900	\$90,000
Medicare	1.45%	Unlimited	Unlimited

Watch out for AMT

Because the alternative minimum tax (AMT) exemption has not been indexed for inflation, more and more taxpayers are finding themselves at risk for it.

If you have a large number of exemptions, a large deduction for state taxes or if you exercised in-

centive stock options, for example, you may be subject to AMT.

Consider this additional tax when estimating your tax liability.

Review portfolio

With the low 15% rate on long-term capital gains, now may

be a good time to sell appreciated stocks and pay the tax. You also should consider taking losses in your investment portfolio. Capital losses can be used to offset capital gains. Any excess loss may shelter up to \$3,000 of ordinary income.

Adjust withholding

Withheld taxes are considered paid evenly throughout the year, regardless of when they are actually withheld from your paycheck.

Therefore, consider increasing your withholding before year end to help avoid potential underpayment penalties.

Tax Strategies



Consider using a credit card to prepay expenses that can generate deductions for this year.



If you expect to pay AMT this year, consider deferring the payment of state taxes and miscellaneous itemized deductions and accelerating income.



Annual gifts to family members can help reduce your taxable estate. When making gifts, give assets you think will appreciate in value. This will enhance your estate planning.

If you wish to make annual financial gifts to family members or others, be sure to complete them by December 31. The annual per-donee exclusion for 2004 is \$11,000.



If you have held stock for over one year that has increased in value, consider donating it to a qualified charitable organization and receive a tax deduction equal to the fair market value of the stock, but you will not have to pay tax on that appreciation.

Individual Tax Rate Schedule

Status	2004 Rates		Estimated 2005 Rates	
	Rate (%)	Bracket	Rate (%)	Bracket*
Single	10%	\$0 - 7,150	10%	\$0 - 7,300
	15	7,151 - 29,050	15	7,301 - 29,700
	25	29,051 - 70,350	25	29,701 - 71,950
	28	70,351 - 146,750	28	71,951 - 150,150
	33	146,751 - 319,100	33	150,151 - 326,450
	35	Over 319,100	35	Over 326,450
Head of Household	10%	\$0 - 10,200	10%	\$0 - 10,450
	15	10,201 - 38,900	15	10,451 - 39,800
	25	38,901 - 100,500	25	39,801 - 102,800
	28	100,501 - 162,700	28	102,801 - 166,450
	33	162,701 - 319,100	33	166,451 - 326,450
	35	Over 319,100	35	Over 326,450
Married Filing Jointly	10%	\$0 - 14,300	10%	\$0 - 14,600
	15	14,301 - 58,100	15	14,601 - 59,400
	25	58,101 - 117,250	25	59,401 - 119,950
	28	117,251 - 178,650	28	119,951 - 182,800
	33	178,651 - 319,100	33	182,851 - 326,450
	35	Over 319,100	35	Over 326,450
Married Filing Separately	10%	\$0 - 7,150	10%	\$0 - 7,300
	15	7,151 - 29,050	15	7,301 - 29,700
	25	29,051 - 58,625	25	29,701 - 59,975
	28	58,626 - 89,325	28	59,976 - 91,400
	33	89,326 - 159,550	33	91,401 - 163,225
	35	Over 159,550	35	Over 163,225

Long-term capital gains and dividends are subject to a maximum tax rate of 15% (5% for taxpayers in the regular 10% and 15% tax brackets).

*These brackets have been adjusted for inflation in 2005; however, the IRS has not yet released the official amounts.

Tax Strategies

✓
If your employer offers a retirement plan that matches your contributions, take full advantage. It's "free money" and is tax deferred.

✓
Reduce your tax bill and increase your retirement savings by investing in an individual retirement account. You have until April 15, 2005, to make a contribution for 2004.

✓
Storm victims who incurred losses as a result of a natural disaster may be eligible for a tax deduction for this year or last year.

To be eligible you must live in a place designated by the President as a natural disaster area.

Then, you can either take a "casualty loss" deduction this year, or, to speed a tax refund, file an amended return for last year. Of course, the loss must be reduced by any insurance recoveries you received.

Investing in 529 plans

Contribute to a "529" tuition plan, a plan established by a state or educational institution that provides account owners and beneficiaries with a tax-free way of paying for higher education costs.

Investments in these plans grow tax free, and some states provide for a tax deduction for contributions.

Life insurance can be effective planning tool

Life insurance can be an effective financial-, estate- and tax-planning tool.

Following are helpful tips:

- ✓ Don't treat life insurance as a commodity; always consult a qualified advisor before you formulate or change your insurance and financial plans
- ✓ Make sure your life insurance product matches your needs
- ✓ When determining policy amounts, consider inflation, increasing college costs and other dynamic factors
- ✓ Do not name minors or irresponsible adults as outright beneficiaries; instead, consider a trust or settlement option

Individual year-end

- ✓ Save federal estate taxes with an irrevocable life insurance trust
- ✓ Your business may be able to provide life insurance on a more cost- or tax-effective basis
- ✓ Obtain written confirmation of policy and beneficiary status from your insurer; review your policies at least every three years
- ✓ Generally, your estate should not be named as the beneficiary
- ✓ Name at least two backup beneficiaries
- ✓ Remember, term insurance runs out and becomes more expensive as you grow older

Bunch expenses

If your itemized deductions are limited because of your income, or they do not exceed the standard deduction, consider "bunching" expenses by either prepaying next year's expenses or delaying payment of the current year's.

Consider renewing subscriptions to professional journals, paying union or professional dues, enrolling in (and paying tuition for) job-related courses, etc., to "bunch" into 2004 miscellaneous itemized deductions subject to the 2%-of-AGI floor.

Marriage penalty

Those who are contemplating marriage or divorce need to watch out

for the effect the tax marriage penalties could have.

Marriage penalty relief has been extended for the 15% tax bracket and the standard deduction, but other tax marriage penalties remain.

Required minimum distributions

If you are 70 ½ years of age or older, you must take required minimum distributions from your traditional individual retirement account (IRA).

If you reached this age in 2004 or will reach it in the next few years, you may have planning alternatives.

Deducting home mortgage loan points

Home mortgage loan points, *e.g.*, loan origination fees, loan charges, loan discounts or discount points are basically upfront interest charges.

Mortgage interest is generally deductible when paid, but points are subject to special rules.

Points paid to refinance a loan must be ratably deducted over the life of the loan unless used for home improvement.

The same applies to points paid for a home-equity loan not used for home improvement, which are deducted over the life of the credit line.

However, any remaining points are immediately deductible when you sell your home or pay off your mortgage.

Standard Mileage Rates for 2005

Business	40.5 cents per mile
Charitable	14 cents per mile
Medical & Moving	15 cents per mile

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Basic Standard Deduction

	2004	2005
Married - joint	\$9,700	\$10,000
Head of household	7,150	7,300
Single	4,850	5,000
Married - separate	4,850	5,000

Bonds may have tax implications

Interest income from exempt bonds is generally not subject to federal income tax; however, bondholders should be aware of potential tax implications.

Many retirees are often surprised to learn tax-exempt interest may increase the amount of Social Security benefits subject to income tax.

In addition, many states tax interest on exempt bonds issued by other states.

Capital gain or loss can result from a sale or redemption if the sale price exceeds the original purchase price, plus original issue discount (OID) or less bond premium accrued at the time of sale.

OID is the excess of the amount payable upon the bond's maturity over its original issue price.

Bond premium is the excess of the bond's original issue price over the amount payable upon maturity.

In addition, bondholders may be subject to ordinary income tax rates on a bond's market discount upon sale of the bond.

Market discount generally occurs when a bond is purchased on a secondary market for less than its original issue price.

Bondholders also must be aware that interest from "private activity" bonds (typically issued by municipalities to benefit a private business) are potentially subject to the alternative minimum tax. □

Retirement Plan Contribution Limits

Individuals 50 and over can make elective catch-up contributions to their retirement accounts. The catch-up amounts are in

addition to the existing contribution limits, making the maximum allowed elective deferral retirement contributions:

	2004	2005
401(k), 403(b), 457 & SAR-SEP Plans - Under 50	\$13,000	\$14,000
401(k), 403(b), 457 & SAR-SEP Plans - 50 & Older	\$16,000	\$18,000
Traditional and Roth IRAs - Under 50	\$3,000	\$4,000
Traditional and Roth IRAs - 50 & Over	\$3,500	\$4,500
SIMPLE Plans - Under 50	\$9,000	\$10,000
SIMPLE Plans - 50 & Over	\$10,500	\$12,000

Elective deferrals are amounts an employee instructs the employer to take out of regular pay and put into a pension account. Employers with profit-sharing plans are required to contribute funds to employee pension accounts. The total sum of an employee's combined pension contribu-

tions can't exceed \$41,000 for 2004. An employer's tax deduction for contributions can't exceed 25% of all employees' annual compensation, taking into account individual compensation. For defined benefit plans, the maximum annual benefit is limited to \$165,000 for 2004. □

Tax Strategies



You may want to pay contested state and local taxes this year to get a current deduction while continuing to contest them next year.



Deductible losses from partnerships and S corporations are limited to your basis, generally the amount of your investment plus undistributed taxable income and minus losses.

If you have such losses, review your basis with your advisor; you may want to discuss ways to increase it.



To get tax-free reimbursements for over-the-counter drugs like aspirin and antacids, increase the amount set aside for next year in your employer's health flexible spending account.

Tax Strategies



If the value of your inventory has declined, you may be able to claim a deduction before year end by making a bona-fide offer to sell the inventory at the lower price.

For obsolete inventory, you can claim a deduction if you dispose of the inventory before year end.



Businesses that receive advance payments from customers for services can now elect to defer that income if they do so for financial statement purposes.

This affords affected businesses the opportunity to defer taxes on income they have already collected in 2004; however, a special filing is required, so you should discuss this with your BKD advisor now.



Businesses that prepay insurance, licenses and certain other expenses and capitalize them as prepaid expenses may benefit in 2004 from new rules that allow such qualifying expenses to be deducted when paid; however, a special filing is required, so discuss this with your BKD advisor now.

Deduct business equipment

Current tax law has greatly expanded the amount of depreciation available to taxpayers.

The Section 179 expensing provision allows taxpayers to immediately expense up to \$102,000 of qualifying property, although the amount available is reduced if your total equipment purchases for the year exceed \$410,000.

Business retirement plans

If you are self-employed or a small-business owner, consider implementing a Keogh, a simplified employee pension (SEP) or a Savings Incentive Match Plan for

Employees (SIMPLE).

Remember, if you want to contribute to a Keogh, the plan must be adopted before year end, but the contribution can be deferred to the due date of your tax return.

SEPs and SIMPLEs do not have annual reporting requirements, and each is relatively easy to set up. You can either complete the appropriate IRS form or a plan adoption agreement.

FLSA update

New overtime rules were implemented August 23 under the *Fair Labor Standards Act* (FLSA).

There is an ongoing legislative attempt to block the funding necessary to enforce the new rules, but the President has threatened to veto any such legislation.

Meanwhile, the new overtime rules remain in effect and the Department of Labor (DOL) will continue its education and enforcement efforts. If you are an employer, take steps to ensure compliance with the new overtime rules.

For more information, see the June issue of the *Advisor* and the DOL web site: www.dol.gov.

Bonuses

Family-owned C corporations with high taxable income should consider paying bonuses to family

members before year end to avoid the double tax on dividends; bonuses must be reasonable and paid to only those family members who worked for the corporation during the year.

Partner payments

If you are a retiring partner, self-employment taxes on your retirement benefits can easily be avoided, but careful planning is required:

- ✓ The payments must be periodic and paid for life; one option is to reduce payments to a nominal amount after five or 10 years
- ✓ Retiree cannot render any services to the partnership after retirement and must avoid "of counsel" or consulting arrangements
- ✓ Except for the payment of retirement benefits, remaining partners can have no additional obligations to the retiree
- ✓ Retiree capital account must be paid in full within the calendar year retirement benefits commence

Document cell phone use

Cell phones are essential to businesses; however, the IRS has historically denied such deductions where documentation is inadequate.

To support your tax deductions, document business cell phone use by retaining billing statements, and be able to document:

- ✓ Expense amount
- ✓ Time and place of calls
- ✓ Business reason for calls

The same documentation procedures apply when deducting

Travel Rates

New simplified per-diem travel rates became effective October 1, 2004. Employers can give employees these per-diem allowances instead of reimbursing actual business travel expenses. Use of the per-diem rates greatly simplifies recordkeeping requirements needed to substantiate deductions for business travel.

	Rate Per Day
Lodging, Meals & Incidentals "High-Cost Localities"	\$199
Lodging, Meals & Incidentals Other Localities	\$127
Meals & Incidentals Only "High-Cost Locality"	\$46
Meals & Incidentals Only Other Localities	\$36
Transportation Industry: Meals & Incidentals Continental U.S.	\$41
Transportation Industry: Meals & Incidentals Outside Continental U.S.	\$46

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expenses for the business use of an automobile.

Lease or purchase

Business owners must often decide whether to lease or purchase equipment outright.

This decision involves more than simply comparing the purchase price to the lease payments, including:

- ✓ When must equipment be replaced; technological equipment may lend itself to leasing, while other types may not
- ✓ Service and repair costs; leasing arrangements often include maintenance
- ✓ Do you have cash available to purchase the equipment outright?
- ✓ How will financing equipment affect your ability to get credit for other purchases?

- ✓ If you own equipment used in a trade or business, you are generally entitled to a depreciation tax deduction (or a complete or significant first-year write-off)
- ✓ Leased equipment generally gives you a deduction when lease payments are made

Digital receipts satisfy T&E

One of the most tedious chores imposed on businesses is compliance with IRS travel and meals and entertainment (T&E) substantiation requirements.

The IRS has historically denied tax deductions where taxpayers are not in strict compliance; however, it has approved a digital receipt system to document T&E business expenses, offering relief from saving most receipts and paperwork.

In summary, a business gives credit cards to employees for qualified business expenses.

Along with the cards, both the business and its employees have access to a web site maintained by the credit-card issuer where employees can substantiate the business purpose for each expenditure amount.

The credit-card issuer mails a detailed monthly report to the company that accounts for all charges, which supervisors review and approve.

The company also performs periodic audits of employee accounts. The result? Generally, only paper receipts are required for nonitemized hotel bills, meals and entertainment expenses exceeding \$75 and for any expenses not paid with the issued credit cards. □

Tax Strategies

✓
Accrual-basis businesses should consider deferring sales into 2005, accelerating purchases into 2004 where appropriate.

✓
Cash-basis businesses should consider paying outstanding payables and deferring outstanding receivables, where appropriate; however, the Jobs Act (see page 2-3) may affect this decision.

✓
C corporations with significant investment income should discuss their exposure to the personal holding company tax with a BKD advisor. Affected taxpayers should consider taking steps, including paying dividends before year-end, to avoid this penalty tax.

✓
Qualifying service businesses (especially contractors, banks and health care providers) that have gross receipts under \$10 million may be able to convert to the cash method of accounting.

This allows such businesses to defer taxes on 2004 receivables to 2005 when payment is received and allows for the deduction of most 2005 expenses if prepaid in 2004; however, a special filing is required, so you should discuss this with your BKD advisor now.

State tax incentives: what you need to know

by Rob Mandel, Kansas City, rmandel@bkd.com

State tax incentives are often seen as “free money” available when a business is purchased or expands.

The focus of economic incentives is usually on new jobs and capital investment in certain industries that a state seeks to promote, including:

- ✓ Tax credits and disbursements for new employees or capital investment
- ✓ Property-tax abatements
- ✓ Low-interest loans

States often seek to promote these industries:

- ✓ Manufacturing
- ✓ Corporate headquarters of multi-state businesses
- ✓ High technology

Most states require you to apply for and negotiate incentives before you commit to a project; states often reject applications for incentives if you have already committed to a project.

Because state incentives are often highly political, their features sometimes change between political administrations.

Therefore, beware of underfunded incentives or those that do not apply to your particular situation, *e.g.*, those that may only apply in a particular zone or with a particular class of employees.

Though incentives should not be the primary reason for a business decision, they should make a good business decision even better.

* * *

BKD's state and local tax (SALT) advisors can help you reach the best decision for your business. □

Case for investing in low correlation assets

by Wayne Starr, BKD Wealth Advisors, LLC, wstarr@bkd.com

The merits of adding low correlation assets, *e.g.*, commodities, to a portfolio were covered in “Commodities Enter Investment Mainstream,” a September 9, 2004, *Wall Street Journal* article by Michael R. Sesist.

In his article, Sesist says, “Mainstream investors, such as pension funds, insurance companies and university endowments—even Harvard’s—are pumping money into commodities.”

According to Sesist, investors often use indexes linked to the price of commodities, a distinct asset class just as stocks, bonds and real estate are.

Asset allocation is all about lessening volatility by diversification, both within *and* across asset classes. Why? Because asset classes do not all move up and down together.

Commodities are distinct from stocks and bonds and react differently to changing economic conditions. It is one of the few assets that benefit from inflation.

The table below shows the historical correlations between a representative commodity index, and stocks, bonds, inflation and changes in inflation.

	One Month	YTD	2003	Annualized			
				1 year	3 Year	5 Year	Since Inception (1992)
DJAIGCI	6.84%	14.24%	23.93%	28.12%	18.82%	13.85%	7.35%
S&P 500 Index	1.08%	1.50%	28.68%	12.62%	6.33%	11.08%	10.16%

Source: Dow Jones AIG Commodity Index & Morningstar

In the period January 1991-June 2003, both the S&P 500 Index and the Lehman Brothers Aggregate Bond Index showed negative correlation to the Dow Jones AIG Commodity Index (DJAIGCI).

During the same timeframe, there was a positive correlation between the DJAIGCI and changes in the rate of inflation. Rising inflation is often negative for both stocks and bonds but has historically been a positive for commodity prices.

The “Annualized Return” chart above shows annualized returns for the DJAIGCI and the S&P 500 Index as of September 30, 2004.

A few methods to introduce commodity exposure to your portfolio include buying oil company stocks, energy specific mutual funds or even investing directly in commodities via futures contracts; however, these methods may result

in a fairly concentrated exposure to only one or a handful of commodities, which could potentially increase the risk of your portfolio.

For example, by only purchasing oil company stocks, you would have no exposure to other commodities, such as coffee, gold, live cattle, wheat, etc.

In addition, buying individual commodities via futures contracts can be volatile. On the other hand, a commodity index provides passive exposure to a broad range of commodities.

The DJAIGCI, one of three recognized indices, is composed of futures contracts on 20 different commodities. Some of the larger allocation categories currently include petroleum, 21%; grains, 18%; industrial metals, 17%; and natural gas, 12%.

Changes to the index’s composition are not determined by manager discretion but by preset rules.

One advantage of commodity exposure that tracks a broad index is that commodities are not highly correlated with each other and index returns should be less volatile than the returns on an individual commodity. The index gives you instant diversification.

Commodities are a distinct asset class with returns largely independent of stock and bond returns. Therefore, adding broad commodity exposure can help diversify a portfolio of stocks and bonds, lowering risk and potentially boosting return.

Achieving this diversification has been made easier with the development of investment products that passively track a broad range of commodities.

The investment selection process BKD Wealth Advisors uses is rigorous. Before we recommend an asset class and the investment to fund it, we study both in depth.

Based on our research, we believe a 5% to 10% position in low correlation assets, such as commodities via a diversified index, can positively affect portfolio performance. □

¹ Quarterly returns for January 1991-June 2003

² CPI-U

³ March 1991-June 2003

Historical Correlations

Asset Class Correlations	DJAIGCI	S&P 500	LBAG
Dow Jones-AIG Commodity Index ¹ (DJAIGCI)	1.00		
S&P 500 Index	-0.30	1.00	
Lehman Brothers Agg. Bond Index (LBAG)	-0.10	-0.50	1.00
Inflation ²	0.40	-0.30	-0.10
Change In Inflation ³	0.40	-0.10	-0.20

Source: Bloomberg, PIMCO

Market commentary

by Jeff Layman, BKD Wealth Advisors, LLC,
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Bonds were the third quarter's biggest surprise, posting strong returns and reversing the negative results of the first half of the year.

Stocks were unable to benefit from continued strong corporate earnings growth in the second quarter, as all of the major equity indices declined in July through September.

With the exception of the tech-heavy NASDAQ Composite Index, the equity averages remained in positive territory for 2004 year to date.

During the quarter, the Federal Reserve (the Fed) raised interest rates twice for a cumulative increase in the Fed Funds rate of .75% since the first move in June.

Despite this, bond yields dropped significantly from the levels reached in May, as investors reacted to signs of a softening economy and moderating inflation expectations.

The benchmark 10-year Treasury note yield fell from 4.90% in May to end the quarter at 4.10%. The current yield is below the level at the start of the year, 4.25%.

Despite oil prices moving above \$50 per barrel (up from \$32 at the beginning of the year), the overall rate of inflation has remained tame.

For the year ended August 31, the Consumer Price Index (CPI) rose 2.7%. In part, this is because the value of oil consumption has fallen from 9% of gross domestic product (GDP) in 1979 to under 3% today, reducing the impact of this price increase on inflation and

the economy.¹

Second quarter GDP growth was revised upward from 2.8% to 3.3%. Government data indicated the economy experienced a "soft patch" over the summer but appears to have reaccelerated in the third quarter.

Estimates of economic growth for the quarter just ended are in the area of 4%. Economic growth will likely face a greater headwind the remainder of this year and into 2005, because of rising interest rates and elevated commodity prices.

Earnings for companies in the S&P 500 have grown by more than 20% year over year in each of the first two quarters of 2004.

Prior year comparisons will become more difficult beginning in the third quarter; therefore, earnings growth is expected to slow. The expectation for growth in corporate earnings for the just completed quarter is approximately 14%.

Business free cash flow (cash

flow minus capital expenditures) hit an estimated record high of \$127 billion in the second quarter.²

Many U.S. companies have become very healthy over the past two years and have accumulated significant cash balances that could be used to increase dividends and capital investment and also to reduce debt.

The valuation of the market is currently 17 times 2004 estimated earnings and 15 times 2005 esti-

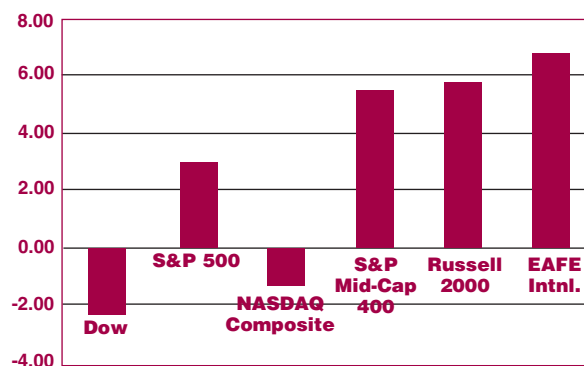
mates. These are reasonable levels, particularly with inflation under 3%.

With election uncertainty resolving itself in November, there remains a fair chance the market can stage a meaningful rally between now and the end of the year. □

¹ Source: **Oil and Gas Journal**, CS First Boston

² Source: **13-D Research, Inc.**

Selected Equity Index Returns Through 10/29/04



Is a revocable trust right for you?

by Grant Glackman, BKD, LLP, Evansville,
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A revocable trust is a common estate planning tool because it can add considerable flexibility and save money. Unlike an irrevocable trust, the revocable trust can be changed any time its creator desires.

Typically, individuals establish a revocable trust during their lifetime, and, at death, the trust becomes the primary distribution mechanism for their assets.

Following are a few of the benefits of a revocable trust:

✓ **Avoid probate** - When you die, family members and other beneficiaries can avoid the potentially expensive process and delays of probate.

✓ **Privacy** - If probated, your will and assets become part of the public record; however, in most cases, the details and assets of a revocable trust are unpublished.

✓ **Protection for incapacity** - During life, you are normally your own trustee of a revocable trust; however, provisions are made for a successor trustee in the event of incapacity. This can prevent the need to name someone to legally take control of your financial affairs.

✓ **Limited creditor protection** - In some states, transferring your property to a revocable trust can protect it against creditors. At death, protection is strengthened when your beneficiaries become involved.

While a revocable trust is not for everyone, it can be an effective way to structure your estate plan. □

Merger & acquisition activity continues to gain momentum

by Steve Blumreich & Jason Corson, BKD Corporate Finance, LLC, sblumreich@bkd.com and jcorson@bkd.com

BKD Corporate Finance continues to see a strong rebound in the number and value of mid-sized companies coming to market.

After reaching record levels in 2000, merger and acquisition (M&A) activity declined dramatically in 2001 and 2002. The increase began in the first quarter of 2003 and continues to gain momentum as we head towards the end of 2004.

The improving economy, large amounts of private equity, low interest rates and rising corporate earnings have driven M&A volume in 2004.

Valuations increase

U.S. M&A activity continued to make gains during the first nine months of 2004. The number of acquisitions completed through the end of September 2004 surpassed that of the full year 2002 and has almost eclipsed that of the full year 2003.

As acquisition activity increases, we also are seeing valuations for mid-sized companies increase. Aggregate deal value through three quarters in 2004 has surpassed that of the full year 2003.

Average valuation multiples are up from 5.8 times EBITDA (earnings before interest, taxes, depreciation and amortization) in 2002 to 6.56 times during first half of 2004 for transactions of less than \$250 million.

Strategic buyers

2004 and 2005 should shape up to be very good years for sellers with buyer demand increasing. Strategic buyers are re-entering the M&A arena, bolstered by improved financial performance, improvement in the equity markets, low interest rates and increased access to debt and equity financing.

Buyers with strong balance sheets have been aggressively bidding on companies. This is certainly good news for sellers as the re-entry of the strategic buyers increases competition on deals contributing to higher valuation multiples.

In addition, private-equity firms, fueled by an abundance of

capital, continue to aggressively pursue opportunities. □

New name, same corporate finance solution

BKD, LLP's corporate finance subsidiary, BKD Financial, LLC, has changed its name to BKD Corporate Finance, LLC (BKDCF).



Founded in 1994, BKDCF has helped companies and stockholders create an estimated half a billion dollars in corporate value through mergers, acquisitions, sales, recapitalizations, management buyouts, employee stock ownership plans, financing and initial public offering advisory services.

BKDCF has helped companies buy, sell and divest in a wide range of industries, including communications, defense, financial institutions, construction, real estate, health care, manufacturing, technology and wholesale distribution.



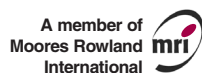
Steve Blumreich

"A real benefit BKD Corporate Finance brings is in the sale of companies—the value to the seller can be dramatically enhanced through the methods we employ," says BKDCF President Steve Blumreich. "We've demonstrated this with many successful transactions, resulting in sales that exceeded the value expectations of our clients."

To find out more about BKD Corporate Finance, LLC, visit www.bkdcorporatefinance.com or ask your BKD advisor for an introduction. □



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