BKD Advisor

Beyond Your Numbers

March 2005

Information to Help You Make Smart Business & Financial Decisions

Standard 2005 mileage rates

Effective January 1, 2005, the standard mileage rate for use of a car (including vans, pickups or panel trucks) is 40.5 cents/mile (business), 14 cents/mile (charitable) and 15 cents/mile (medical and moving).

Until January 1, 2005, the following rates apply: 37.5 cents/mile (business), 14 cents/mile (charitable) and 14 cents/mile (medical and moving).

How state tax amnesty programs work

States use amnesty and voluntary disclosure programs to encourage taxpayers to file and pay back taxes. In return, a state may reduce or alleviate penalties and/or interest. The programs differ with respect to administration and tax periods.

Tax amnesty programs are typically available for a short time, usually a month or two, during which it's a state's goal to collect as many back taxes as possible.

Amnesty is generally available to filers and nonfilers who may have either forgotten to file returns or understated their tax liability. In addition, amnesty is generally available for all tax periods for which a return was not filed.

Six states recently concluded amnesty programs, and other states will likely initiate such programs because they have proved successful in securing what was thought of as lost revenue.

Currently, only California has an active amnesty program; it will run from February 1, 2005, to March 31, 2005. Indiana has proposed legislation to enact a temporary amnesty program.

Voluntary disclosure programs are initiated between a state and a nonfiler. Most states and the District of Columbia have these programs.

To encourage nonfilers to come forward and comply with future filings, a state's voluntary program may reduce the number of years filing is required, or it may reduce or eliminate penalties and/or interest.

State tax revenues increase

Most states have faced revenue shortfalls in the past few years as state spending outpaced tax collections.

As a result, states have become increasingly aggressive in closing loopholes and pursuing nonfilers and out-of-state businesses.

A recent study shows that, overall, state revenues were up 7.5% in 2004, but states show no signs of slowing their search for more revenues.

States continue to share information with each other and with the federal government to identify uncollected revenues. Businesses must be aware of the increased risk of assessments in states they have even minimal connections to.

It pays to be proactive: Identify problem states, assess risk and plan to reduce your state tax burdens.

Deduct January '05 donations to tsunami relief efforts

Taxpayers may claim a charitable deduction on 2004 tax returns for qualifying donations made through January 31, 2005, for the relief of victims affected by the December 26, 2004, Indian Ocean tsunami.

If you are an individual who itemizes deductions and you made tsunami relief donations during January of 2005, you have the option to deduct them on your 2004 tax return rather than waiting to deduct them on your 2005 tax return.

The donations must have been made in cash, by check, money order or credit card to a qualified charity.

In addition, you must have adequate records to show the contributions were made to assist tsunami relief efforts.

New rule benefits automobile dealers

Taxpayers may now defer the taxes on certain upfront fees for services beyond the taxable year of receipt. One type of advance payment that may qualify for deferral is multi-year service warranty contracts.

An automobile dealer that sells such contracts may be able to defer upfront

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receipts if the dealer is the primary obligor under the contract and does not use the "service warranty income method."

Example: Under the new rules, taxes on four-fifths of the sales price for a five-year extended service contract may be deferred to the next fiscal year. Significant tax savings could result, depending on the contract's length and the dollars involved.

New producers' deduction: you may qualify

In the November 2004 **BKD Advisor**, we alerted you to a new deduction for taxpayers that produce qualified items in the U.S.

Since our initial coverage, the government has issued additional guidance, with more to come in the future.

Some details have been issued on which taxpayers qualify for the new deduction:

- Property will be treated as produced in the U.S. if the labor and overhead costs incurred in the U.S. are at least 20% of the taxpayer's total cost of production. If the 20% test is not met, the property may still qualify if, based on all of the facts and circumstances, U.S. production is substantial. If one of these tests is not met, the production does not qualify for the deduction.
- Taxpayers cannot qualify if their only activities in the U.S. are packaging and labeling or designing and developing property produced outside the U.S.
- Contract manufacturers do not qualify if they do not have the benefits and burdens of ownership of the property.
- With regard to construction activities, a general contractor and a subcontractor are both entitled to the deduction.
- Rental income for real property is ineligible, even if the taxpayer constructed the property.
- Food and beverages prepared at a retail establishment do not qualify; however,

Jobs Act limits deductions for personal use of business aircraft

by Steve Bullard, Springfield,
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The *American Jobs Creation Act of 2004* (Jobs Act) provides many new tax benefits for American businesses, including an extension of the 50% bonus depreciation for new aircraft to be used in Part 91 operations and placed in service before January 1, 2006.

However, it also contains a provision that is **not** favorable to noncommercial aircraft owners.

Before the Jobs Act, if a company provided a company aircraft to an employee for personal use, the expenses incurred were deductible if the use of the aircraft was treated as taxable compensation to the employee subject to withholding.

When optional Internal Revenue Service (IRS) tables were used to determine the amount of the employee's taxable income for flights, it was often substantially less than the actual cost of the flight, which allowed businesses a larger deduction relative to the income taxed on the employees' returns.

The new law limits the deductibility of a company's expenses "incurred after October 22, 2004," for travel provided to *officers, directors* and *10% or more owners* when the travel is for entertainment, amusement or recreation.

Companies may no longer take a deduction larger than the amount taxable to these individuals. The following comparison serves as a Jobs Act before and after:

Old law: A corporation allows its CEO to use its aircraft to fly his/her family to a vacation destination. Using IRS tables, the value of the flight is $1,000, but its actual cost to the corporation is $4,000. If the CEO treated the $1,000 as taxable income and the corporation treated the $1,000 as wages subject to withholding, the corporation was entitled to deduct the entire $4,000 cost of providing the flight.

New law: If the CEO treats only the $1,000 as taxable income, the corporation can only deduct $1,000; the remaining $3,000 cost of the flight is not deductible.

There are a number of questions yet to be answered in implementing the new legislation, including:

- Is the limitation applicable only to travel considered to be *entertainment, amusement or recreation* purposes? For example, would a flight to inspect a piece of personal investment property be limited?
- How will mixed business and personal trips be treated under the new provision?
- The new law will surely affect the deductibility of the *direct operating costs* (pilot, fuel, landing fees, etc.). It is unclear whether it also will limit the deductibility of *fixed costs* and depreciation related to personal flights.
- Can a company avoid the limitation by providing an aircraft to officers, directors and 10% or more owners under time-sharing arrangements, dry leases or third-party charters-for-hire arrangements?

Answers to these questions are forthcoming. In the meantime, take care identifying business aircraft expenses incurred after October 22, 2004, as well as the personal use percentages.❖❖❖

Jobs Act imposes new restrictions on NQDC plans

by Mike Dambach, St. Louis,
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November 2004's **BKD Advisor** alerted you to significant new restrictions on nonqualified deferred compensation plans (NQDC) imposed by the *American Jobs Creation Act of 2004* (Jobs Act).

Prompted by corporate scandals at Enron and other companies, the new restrictions impose limitations on the design of NQDC plans, which must now meet distribution, election and funding requirements.

If a plan fails to comply, all cumulative earned and deferred compensation can be included in a participant's taxable income if it is not subject to a "substantial risk of forfeiture." A 20% penalty and interest also will be imposed.

What is an NQDC plan?

An NQDC plan is basically any arrangement—or contract—between an employer and employee that provides for the deferral of compensation and the associated tax, *i.e.,* where compensation is earned in one year but not paid until a future year.

Employees covered under such a plan generally recognize income from it when compensation is distributed to them. An employer's deduction for NQDC plan contributions is delayed until the compensation is taxable to the employee.

These arrangements are typically used to supplement the compensation packages of owners, executives and other key employees and are commonly used to compensate board members and sometimes independent contractors.

NQDC plans include:

- Nonqualified salary and bonus deferral arrangements
- Deferred compensation arrangements under an employment or severance agreement
- Traditional elective top-hat plans
- Rabbi trusts
- Supplemental executive retirement plans (SERPs)
- Nonqualified stock option plans
- Stock Appreciation Rights (SARs)
- Restricted stock plans

The new rules do not apply to qualified tax-favored retirement plans commonly offered to rank and file employees. Plans not affected by the new rules include 401(k), 403(b), simplified employee pensions (SEPs) and traditional bonus, vacation, sick-leave, disability or death-benefit plans.

Effective date

The new rules generally apply to amounts deferred after December 31, 2004. Existing plans materially modified after October 3, 2004, also fall under the new rules' scope.

Treasury guidance

Initial guidance addressed some of the new rules' technical definitions, exceptions and transitional procedures, but many questions remain unanswered.

In response, Congress has authorized the Treasury Department and the Internal Revenue Service (IRS) to provide additional guidance.

Immediate action required

With compliance set for December 31, 2005, employers must identify their NQDC plans now and contact their benefits counsel for help in applying the new rules.

To comply, almost all arrangements will need modification; some will need to be terminated or frozen, and some compensation packages may need reassessment. In addition, certain elections must be made by **March 15, 2005**.

Before you take action, contact qualified legal counsel to review the plan(s) and describe in more detail these intricate new rules.

If you are uncertain whether the new rules apply to an arrangement, contact your BKD advisor as soon as possible to help you make this determination.❖❖❖

food or beverages prepared *and sold* at wholesale do.

- Software downloaded from the Internet generally qualifies; however, fees for online use, customer support and online services do not.
- Farming activities, such as crop and livestock production, qualify.

Ups & downs of interest-only mortgages

To make smaller payments, some home buyers are opting for interest-only mortgages, usually offered as adjustable-rate mortgages where the homeowner only pays interest for a specified number of years within the 15- or 30-year term of the mortgage.

This type of mortgage makes it possible to buy a more expensive home because the initial payments are lower in the early years of the mortgage; however, the longer the interest-only period, the higher the subsequent payments will become when that period ends.

This type of mortgage provides maximum interest tax deductions because the total interest over the term of the mort-

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gage is greater than that of a conventional mortgage.

Conversely, if housing prices drop, the homeowner risks owing more than the home is worth.

IRS rules for reverse like-kind exchanges

Like-kind exchanges are tax deferrals that result from the use of a "qualified intermediary" to first sell property, then identify and purchase replacement property.

But did you know reverse like-kind exchanges ("parking arrangements") also are possible? That's right. You can purchase the replacement property first and then sell your property.

Following are the IRS's rules for reverse like-kind exchanges:

- A qualified intermediary acquires the replacement property and holds it for you
- You formally identify the existing property you will relinquish to the intermediary within 45 days of the date the intermediary takes ownership of the replacement property
- The intermediary sells your relinquished property, then transfers the replacement property to you, completing the entire exchange within 180 days
- You cannot directly or indirectly trade property with yourself or a related party

The result? You do not pay tax on the gain of the sale of the relinquished property until you sell the replacement property.

Use caution: Various strict rules are imposed on taxpayers involved in these exchanges. Noncompliance can result in a surprise tax bill.

When personal loans turn into personal bad debts

Have you made a loan to a family member or a friend that was not repaid? If so, you have incurred personal or nonbusiness bad debts.

Personal bad debts are deductible only if they are worthless: You must establish there was a valid debt that is now worthless; otherwise, the IRS may deny any deduction.

You bear the burden of proof that the loan is worthless. Accordingly, you should have a promissory note that includes interest and a payment schedule; plus, you must demonstrate you made an effort to collect the loan.

Personal bad debts result in short-term capital losses no matter how old they may be, so the deduction is generally limited to your total capital gains, plus $3,000.

Though personal loans are often unavoidable, they are generally not recommended because they can be the source of great bitterness and permanent alienation among friends and family members.

Tax on IRD can surprise heirs

For the most part, inherited property is not included in your income for tax purposes; however, you must include items that are "income in respect of a decedent" (IRD).

IRD is income that would have been included on the final income tax return or on a subsequent return had the decedent not died.

The most common IRD item is a decedent's last paycheck. Normally, this payment would have been included in the decedent's income on his/her final income tax return.

It was not included because the decedent's tax year closed as of the date of death, so, instead, it is taxed as income to whoever receives it (the estate or another individual).

IRD includes not only the final paycheck but any compensation-related benefits paid after death, such as accrued vacation pay or voluntary employer benefit payments a decedent's beneficiary receives.

If you are the recipient of IRD items, you must include them in your income.

Other common IRD items are pension benefits and amounts in a decedent's IRA at death, as well as a decedent's share of partnership income up to the date of death.

A past installment sale also can be an item of IRD; if you hold an installment note at death, your heirs will generally owe income tax on future payments received on the note.

Although IRD must be included in the recipient's income, a deduction may be allowed (as an itemized deduction) to lessen the "double tax" impact caused by also having IRD items subject to the decedent's estate tax.

What gifted property donors & recipients must know

A common estate planning practice is to gift younger generations appreciating real property and investments, such as stocks. If the recipient of gifted property later sells it for a gain, he/she may be subject to capital gain taxes.

Capital gain is determined by subtracting

the recipient's basis in the property from the proceeds.

The recipient's basis is usually the same as the donor's. Conversely, if the recipient sells the property for a loss, the loss is typically not deductible.

Therefore, it is important for donors to also transfer records supporting the donor's basis in the gifted property. If this is not done, it can sometimes make it impossible to determine the basis in the property.

If the recipient cannot prove his/her basis, the IRS may treat the entire proceeds from the sale as a gain.

Inherited IRA may result in income taxes

If you inherit a traditional IRA, you also may inherit a large income tax burden. A determining factor is how you choose to receive the money. If you don't need the money right away, there are ways you can defer or spread out the tax burden.

When you are the surviving spouse - If you are the deceased IRA owner's surviving spouse and beneficiary, there are several ways to defer income taxes on the money.

One is to roll over the inherited IRA into your own new or existing IRA. Rollovers allow the assets to continue to grow tax deferred, but annual IRA withdrawals become mandatory when you reach age 70½.

When you are not the surviving spouse - The IRA distribution rules differ when you aren't the spouse, but you can still spread out the tax burden.

One option may be for you to receive annual distributions from the IRA based on your life expectancy. This will spread out the distributions–and the taxes–over a number of years.

The younger you are, the longer you can stretch out the payments, and the longer the money can stay in the account and benefit from potential tax-deferred growth.

This particular option is not available if the account had no designated beneficiary.

Inherited IRAs are subject to potential risks, such as tax law changes and the impact of inflation.

Hobby or business?

Breeding animals, raising orchids, making craft items, leading travel tours—if you enjoy a hobby, it has the potential for becoming a serious moneymaking venture.

Of course, any venture, whether based on a hobby or not, can lose money, especially in the start-up period.

When this happens, we are often asked whether the losses from the venture can offset other taxable income (wages, pensions, investment income, etc.) so overall taxes can be reduced. The answer is maybe.

Only losses from for-profit activities can offset other taxable income. Generally, the IRS presumes an activity is for profit if gross income exceeds deductions in at least three of the last five tax years (two out of seven years for horse breeding, training or racing).

If it takes your venture longer to turn a profit so you cannot meet this benchmark, you still may be able to deduct your losses if you can prove you are operating the activity with a profit motive.

Even if your activity is treated as a hobby, you can still continue to deduct expenses equal to any revenue you generate to eliminate any tax due on those revenues.

Answer the following questions to find out whether your venture would likely pass muster as a for-profit activity:

- Do you keep accurate books and records for your venture, as well as checking and credit card accounts that are separate from your personal finances?
- Do you have special expertise in the type of venture you are engaged in?
- Do you spend significant time and effort carrying out the venture?
- Do you reasonably expect assets used in the venture to appreciate in value?
- Were you financially successful in carrying on other similar or dissimilar ventures?
- Were your business losses attributable to bad luck, illness or other forces beyond your control?
- Were your occasional profits, if any, significant?
- Is your income or capital from other sources so low that your livelihood depends on the venture's financial success?
- Is there little or no personal pleasure or recreation involved in the venture?

If you answered yes to most of the questions above, chances are the venture can be treated as a for-profit activity.

Ideas for filling rental property

If you own or manage commercial or rental property of modest size, there are economical ways to attract potential tenants:

- Form alliances with area realtors, employers, bankers and others who likely have contact with potential renters
- Make arrangements with major employers to place residential vacancy listings on company bulletin boards
- Join local community organizations and attend community meetings as a source of potential referrals
- List your property with marketing companies that have web sites directed to the real estate market
- Organize continental breakfasts (doughnuts and bagels) and use free-rent contests to promote apartment rentals

Activities like these are relatively inexpensive and can be highly effective in filling vacant rental space. ❖❖❖

Fourth quarter 2004 market commentary & outlook

by Jeff Layman, BKD Wealth Advisors, LLC, jlayman@bkd.com

Two significant market obstacles were removed during the fourth quarter of 2004: Election year uncertainty was resolved, and the price of oil declined from $55 per barrel to below $45. This allowed strong economic and corporate earnings fundamentals to move the market higher.

Most of the major stock market averages ended with double-digit gains for 2004, with nearly all of the return coming in the final two months of the year. Bonds posted reasonable returns, as yields in the intermediate and long-term areas were fairly stable in 2004.

Economic growth for the third quarter was finalized at 3.9%, a slight upward revision to the preliminary estimate. GDP growth for the fourth quarter is estimated to be 3.1%. The economy continues to expand at a healthy pace, with full-year 2004 growth of over 4%.

Despite five consecutive Federal Reserve (Fed) rate hikes, "real" short-term rates remain negative, as current inflation is higher than the current federal funds level of 2.25%; therefore, the Fed's policy is still very accommodative.

The Fed is likely to continue to raise short rates toward parity with the rate of inflation, independent of economic data.

The amount of cash on corporate balance sheets continues to rise. To deploy a portion of this cash, many companies have initiated or increased dividend payouts in 2004, and many also have continued to buy back shares.

Mergers and acquisitions (M&A) are another means of deploying these funds. M&A activity began to increase late in 2004, including the following deals: K-mart-Sears, Johnson & Johnson-Guidant, Sprint-Nextel, Oracle-Peoplesoft, Symantec-Veritas and Jones Apparel-Barneys.

So far in 2005, several other major mergers have been announced, including Proctor and Gamble-Gillette and SBC-AT&T. We anticipate more corporate combinations as the year progresses.

In 2004, the S&P 500 index traded within one of the narrowest ranges in its history. Some analysts believe that market volatility is in long-term decline, in part because of the large increase in the number of hedge funds over the past few years.

As the hedge fund industry has grown, there are more market participants on both the long and the short sides of the market, leading to better price discovery and greater market efficiency. This should lead to less price volatility.

International stocks outperformed U.S. equities again in 2004, posting returns nearly double that of their large-cap U.S. counterparts. Most of the excess return was caused by the weakening U.S. dollar, which magnifies returns to U.S. holders of international assets.

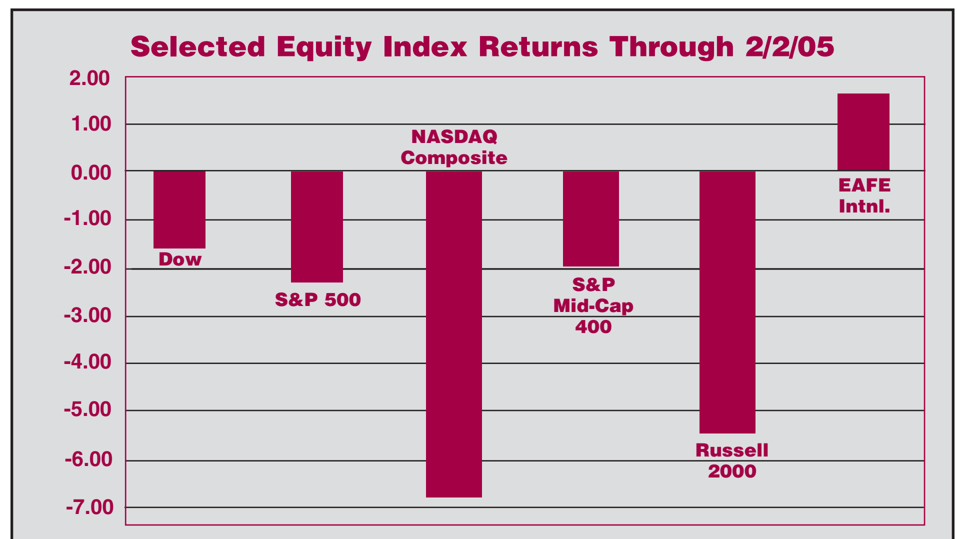
Bonds finished the year posting reasonable investment results. Although short-term rates moved up in conjunction with the rise in the fed fund rate, the 10-year Treasury ended the year about where it started, at roughly 4.25%. Therefore, total bond returns approximated current coupon rates, with no meaningful movement in price.

On a relative valuation basis, stocks still appear attractive compared to bonds. At 17 times 2005 estimated earnings, the "earnings yield" of the S&P 500 is 5.88% vs. 4.25% for the 10-year Treasury note.

Entering 2005, stocks are fairly valued considering current price inflation of less than 3%. The underlying trend and fundamentals of the market are good.

Corporate earnings growth will likely slow in 2005 but should still be in the neighborhood of 10%, based on current data and modest 2005 economic growth assumptions.

Given our belief that interest rates are more likely to rise than fall, P/E multiple expansion is less likely going forward.❖❖❖



Expect the unexpected in 2005

by Jeff Layman, BKD Wealth Advisors, LLC, jlayman@bkd.com

By most measures, 2004 played out as expected, with the stock market posting gains for the 23rd time in the last 27 election years.

Also anticipated was the "back-end loaded" nature of the returns for the year, as history would show that the first half of election years tend to be flat to slightly down.

Finally, the 2004 gain of 10.88% for the S&P 500 is very close to the long run average return for the market.

With 2004 behind us, attention turns to expectations for 2005. Much of the recently published prognostication from Wall Street strategists and analysts leads to a consensus view of an 8% to 10% stock market return in 2005.

This derives from current data indicating the market is "fairly" valued at current levels and the expectation for S&P 500 earnings to grow in the area of 10% this year.

Therefore, without an expansion or contraction of the P/E multiple, market returns should approximate the underlying growth in corporate earnings.

Historical perspective

Despite this logical progression of thought, a few pieces of historical market return data cast doubt on the likelihood of a second consecutive "average" return year in 2005.

First, although long-term market returns have averaged about 11% over the past 80 years, 2004 was only the sixth year of those 80 in which the market's return fell between 10% and 15%.

Second, in one out of every three years over the same time, the market's return was either less than -8% or greater than +33%.

Arriving at the "average" return of 11% has involved enjoying returns of more than 50% in some years (1933, 1954) and enduring losses greater than 35% in other years (1931, 1937).

. . .without an expansion or contraction of the P/E multiple, market returns should approximate the underlying growth in corporate earnings.

Market statistics would indicate a low probability of 10% returns again in 2005. Of greater likelihood are results significantly (+/- 5%) higher or lower than average market returns.

Given the above-trend economic growth experienced in 2004 and fourth-quarter corporate earnings growth that exceeded expectations (19% vs. 15% expected) based on the 350 of the S&P 500 companies that have reported to date, the foundation may exist for an upside surprise.

However, maintaining an appropriate mix of assets to mitigate the inherent volatility of stocks will continue to be a key element in achieving investment success.❖❖❖

Source for statistical information: 2004 Market Data, Ibbotson Associates, Inc.

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Beyond Your Numbers

Recently issued FASB guidance may affect your business

by Michelle Mahoney, Springfield, mmahoney@bkd.com

The Financial Accounting Standards Board (FASB) recently issued guidance that may affect your business.

FIN 46 update

One of the most controversial standards effective for many companies in 2005 is the revised Financial Accounting Standards Board Interpretation No. 46 (FIN 46R), *Consolidation of Variable Interest Entities*.

FIN 46R interprets Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (as amended), which requires consolidation based on voting majority. It also introduces the concept of a variable interest entity and establishes new standards for determining under what circumstances consolidation is required.

The interpretation broadens the concept of control and will result in the consolidation of significantly more entities than under preview guidance.

Specifically, adoption of FIN 46R may result in consolidation of (not all-inclusive):

- Leasing arrangements with another entity controlled by the company's owners
- Real estate partnerships or joint ventures
- Construction joint ventures
- Equity investments where exposure to losses is limited by guarantees or by other means

The provisions of FIN 46R are complex and involve significant judgment; therefore, it is important to evaluate these types of relationships early in the year to properly plan for implementation of this new standard.

Mandatory expensing

Revised FASB Statement No. 123 (FAS 123R), *Share-Based Payment*, requires companies to measure the cost of services received from employees in exchange for awards of share-based compensation based on the grant-date fair value of the equity instruments issued or on the fair value of the liabilities incurred.

The cost is then recognized in the income statement over the period during which an employee is required to provide services in exchange for the award (usually the vesting period).

In addition, the fair value of liabilities incurred in share-based transactions with employees shall be remeasured at the end of each reporting period through settlement. Previous guidance only required disclosure of compensation cost in the footnotes to the financial statements.

FAS 123R excludes from its scope shares held in an employee stock ownership plan, which will continue to be accounted for in accordance with SOP 93-6.

The revised statement is effective for awards granted, modified, repurchased or cancelled during fiscal years beginning after December 15, 2005, with earlier implementation required for public companies. Certain other transitional provisions may apply.

Inventory costs

FASB also has recently issued Statement No. 151 (FAS 151), *Inventory Costs – an Amendment of ARB No. 43, Chapter 4*. This pronouncement requires abnormal freight and handling costs and all wasted materials (spoilage) be recognized as current-period charges rather than as a portion of inventory cost.

In addition, it requires that allocation of fixed production overheads to inventory be based on normal capacity of the production facilities. FAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005.

Take action

These recently issued pronouncements may have a significant impact on your financial statements, making it important to evaluate the new guidance early to determine if additional action is required to avoid unintended consequences.

Contact your BKD advisor for more information about these or other recently issued standards.❖❖❖

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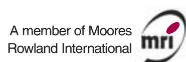

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