BKD Advisor
Beyond Your Numbers
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Information to Help You Make Smart Business & Financial Decisions

IRS to refund long distance telephone excise taxes

A 3% excise tax applies to toll telephone service charges that vary in amount with the distance and elapsed transmission time. This tax also applies to local service and to certain flat-rate long distance plans.

Most modern long distance and cellular charges are based on elapsed time, not distance. The IRS historically argued such charges were nonetheless subject to the tax and required service providers to continue to collect it. However, because a large number of courts disagreed with the IRS, it was forced to change its position.

The IRS ceased tax collection after July 31, 2006, and will refund taxes paid between February 28, 2003, and August 1, 2006, on all long distance telephone charges and bundled service (local and long distance service provided under a plan that does not separately state the charge for the local service). **You can request a refund on your 2006 income tax return.**

Individuals may base claims on actual tax paid (this will require digging out your old phone bills) or, to help reduce paperwork, individuals may rely on IRS tables that have yet to be released. As the rules are currently written, businesses must use actual tax paid from old bills. Taxpayers who are not otherwise required to file a return must do so to receive a refund.

Alternatively, all taxpayers may request a refund from their telecommunications providers. Providers are allowed to issue such refunds but are not required to. In addition, the IRS says it will not act on previous refund claims for services billed after March 1, 2003.

This saga may not be over yet, as various class action lawsuits have already been filed against the IRS over its refund plan.

More corporations & tax exempts required to e-file

Beginning with 2006 returns, corporations, including S corporations, are required to electronically file income tax returns if their assets equal or exceed $10 million for 2006 and they file at least 250 “returns” a year. Returns include Forms W-2 and 1099.

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Correction

A July 7 **BKD Advisor Alert**, “The New Texas Gross Margin Tax,” contained a misprint: “The law applies a tax rate (**fi%** for retailers...” should have read “The law applies a tax rate (½% for retailers...”

To view the corrected Alert visit **http://www.bkd.com**. ❖❖❖

Major tax act: new law will affect individuals, corporations & investors

The *Tax Increase Prevention and Reconciliation Act of 2005* (TIPRA) retroactively extends a number of popular tax breaks that expired at the end of 2005, as well as some due to expire in future years. Signed into law May 17, 2006, it also contains a number of revenue raisers.

Alternative minimum tax (AMT) relief for individuals for 2006 is TIPRA’s centerpiece, flanked by (1) a two-year extension of the low tax-rate treatment for capital gains and qualified dividends and (2) a two-year extension of the favorable Internal Revenue Code (IRC) Section 179 expensing provisions for businesses.

TIPRA also boosts the kiddie tax age from under age 14 to under age 18, which is one of several revenue raisers designed to help meet the $70-billion tax reconciliation target. A recap of TIPRA’s key changes follows, including how TIPRA is expected to affect individuals, corporations and investors.

AMT relief for middle-income taxpayers

The AMT—originally enacted to make sure wealthy Americans did not escape paying their taxes—has come to affect more middle-income taxpayers because the exemption amounts that reduce or eliminate AMT for *most* taxpayers are not indexed for inflation.

Exemption amounts are phased out for taxpayers whose AMT income exceeds

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specified amounts. In recent years, Congress raised AMT exemption amounts to provide a measure of relief; however, for 2006, those amounts were scheduled to fall back to those that applied in 2000.

This would have brought millions of additional middle-income taxpayers under the AMT system, resulting in higher federal tax bills for many taxpayers and higher compliance costs associated with completing the complicated Internal Revenue Service (IRS) AMT form.

Once again, Congress has relied on a temporary fix to the problem—a one-year extension of the 2005 AMT exemption amounts, increased slightly for 2006:

- $62,550 for married individuals filing jointly and for surviving spouses
- $42,500 for unmarried individuals
- $31,275 for married individuals filing separately

These exemption amounts phase out for certain higher-income individuals.

Another TIPRA provision provides AMT relief for those with personal tax credits. The tax liability limitation rules generally provide that certain nonrefundable personal credits—including dependent care, care for the elderly and disabled and Hope Scholarship and Lifetime Learning credits—cannot effectively offset AMT.

Temporary provisions had been enacted that permitted these credits to offset the entire regular and AMT liability through the end of 2005. The new law extends this temporary provision to tax years beginning in 2006.

Planning tip: Many more individual taxpayers will be subject to AMT unless similar relief is provided for 2007. To learn if you could be subject to AMT, contact your BKD advisor to project both your 2006 and 2007 income tax liabilities.

If it appears you will be subject to AMT, your BKD advisor may be able to suggest planning alternatives based on your particular situation.

Preferential tax rates extended

In 2003, Congress passed a measure to lower the tax rate on most dividends from as high as 38.6% to 15% and to lower the rate on most capital gains from 20% to 15%.

That measure was due to expire at the end of 2008, but the new law extends these favorable tax rates through 2010.

Planning tip: We cannot predict the future, but, because these lower rates could expire, think twice before planning to defer capital gains past 2010 via like-kind exchanges or installment sales.

Kiddie tax now applies to older kids

Under pre-TIPRA law, children under age 14 pay tax at their parents' highest marginal rate on taxable investment income exceeding $1,700. The new act raises the age of children affected by the kiddie tax to include those under age 18.

Planning tip: If this tax affects your child, consider investing his/her earnings in a

TIPRA: international provisions

The new law makes two changes regarding controlled foreign corporations (CFCs): The first provides a two-year extension of the "active financing exemption." Important to the financial services industry, this exemption dates back to 1997 and was due to expire at the end of this year. It provides that U.S. companies are not taxed on the active business income earned abroad by their foreign subsidiaries until the income is returned to the American parent.

The second CFC change has to do with look-through treatment of payments between related CFCs under foreign personal holding-company income rules. TIPRA adds a new temporary exception from subpart F for dividends, interest, rents and royalties received by one CFC from a related CFC to the extent attributable to nonsubpart F income of the payor. This provision is effective for tax years beginning after December 31, 2005, and before January 1, 2009.

TIPRA also codifies proposed regulations for earnings stripping rules as they apply to a corporation that owns an interest in a partnership. For this purpose, the new law provides that such a corporation's share of (1) partnership liabilities, (2) interest income and (3) interest expense will be treated as those of the corporation. This provision is effective for tax years beginning on or after May 17, 2006.

In addition, TIPRA affects U.S. citizens working abroad by making three changes to the foreign-earned income exclusion and housing allowance:

- Income excluded as either foreign-earned income or as a housing allowance is included for purposes of determining the marginal tax rates applicable to nonexcluded income.
- Income exclusion is indexed for inflation starting in 2006 instead of 2008 under pre-TIPRA law.
- The base housing amount used in calculating the foreign housing cost exclusion in a taxable year is 16% of the amount of the foreign-earned income exclusion limitation instead of the previous 16% of the U.S. government employee grade GS-14, step 1 amount.

  Reasonable foreign housing expenses exceeding the base housing amount remain excluded from gross income, but the amount of the exclusion is limited to 30% of the taxpayer's foreign-earned income exclusion. ❖❖❖

corporations & investors. . .

Section 529 college savings plan or Coverdell Education Savings Account, which allow tax-free appreciation of investments.

In addition, parents can invest a child's funds in (1) Series EE and I bonds, (2) tax-free municipal bonds, (3) growth stocks, (4) mutual funds, (5) real estate or (6) other investments that can build wealth while deferring income tax until the child reaches age 18. However, tax savings should not be your top priority when selecting an investment.

Planning tip: If you own a family business and hire your children to work for it, what they earn is not subject to the kiddie tax and also generates a business deduction. (The wages must be reasonable and for work actually performed.) Earned income that isn't sheltered by the standard deduction will be subject to tax at the child's tax rate, not the parents'.

Converting traditional IRAs to Roths

Under pre-TIPRA law, only individuals with modified adjusted gross income of $100,000 (as adjusted for inflation) or less could convert their traditional individual retirement accounts (IRAs) to Roth IRAs.

Beginning in 2010, the $100,000 limit is eliminated. In addition, for conversions occurring in 2010, the amounts to be included in income will be spread ratably between 2011 and 2012.

Planning tip: Compare the advantage of tax-free future growth in a Roth IRA to the disadvantage of acceleration of tax at the current tax rates. Though it's still years away for higher-income individuals, contact your BKD advisor to learn more about the conversion option.

Increased expensing for small business

Under IRC Section 179, a taxpayer other than an estate, trust and certain noncorporate lessors may currently elect to deduct (rather than depreciate) up to a specified amount of the cost of most new or used tangible personal property placed into service during the tax year in the taxpayer's trade or business.

The maximum dollar amount that may be deducted for 2006 is $108,000. Under pre-TIPRA law, this amount was to drop to $25,000 for property placed in service in tax years beginning after 2007.

The taxpayer's maximum annual Section 179 expensing amount is reduced dollar for dollar by the amount of qualified expensing-eligible property that he/she places in service during the tax year that exceeds a phase-out amount. This amount is $430,000 for 2006. Under pre-TIPRA law, this amount was to drop to $200,000 for property placed into service in tax years beginning after 2007.

Off-the-shelf computer software is eligible for this expense election. This was set to expire in tax years beginning after 2007.

A Section 179 election or revocation may be made without prior IRS consent on an amended federal tax return. Pre-TIPRA laws did not allow this in tax years beginning after 2007.

The new law extends all these Section 179 provisions to tax years beginning before 2010.

Modifications to rules for tax-free corporate divisions

The new law simplifies the active business test for tax-free corporate spin-offs. To determine if this test is satisfied, look at all corporations in the distributing corporation's and the spun-off subsidiaries' respective affiliated group. This change applies for distributions after May 17, 2006, and before 2011.

TIPRA also curtails tax-free treatment for most cash-rich split-offs where either the distributing corporation or the controlled corporation is a disqualified investment corporation.

Musical works & copyrights

Under pre-TIPRA law, capital assets did not include copyrights, literary, musical or artistic compositions, letters or memoranda or similar property held by a taxpayer whose personal efforts created the property.

As a result, when a taxpayer sells the copyright he/she owns in a book, song or painting that he/she created, gain from the sale is treated not as capital gain but as ordinary income, which is generally taxed at a higher rate.

Under the new law, the taxpayer can elect to treat the sale or exchange of musical compositions or copyrights in musical works created by his/her personal efforts as the sale or exchange of a capital asset. The change applies for sales or exchanges in tax years beginning after May 17, 2006, and before 2011.

TIPRA also allows taxpayers to elect to amortize over five years, expenses paid or incurred in creating or acquiring certain musical works and copyrights. This five-year amortization method is an alternative to the income-forecast method of accounting for these expenses.

Provisions for tax-exempt organizations

TIPRA imposes a new excise tax on tax-exempt entities that are party to prohibited tax-shelter transactions, as well as on entity managers who knowingly approve prohibited tax-shelter transactions.

Further, tax-exempt entities must disclose to the IRS their participation in prohibited tax-shelter transactions. The $100 per-day penalty for failure to disclose is stiff.

To help protect exempt entities from unknowingly participating in such a transaction, the new law provides that the taxable parties of a prohibited tax-shelter transaction must disclose such tax-shelter status to any tax-exempt entity that is a party to the transaction.

In addition, tax-exempt interest paid after 2005 is subject to information reporting in the same manner as interest paid on taxable obligations. ❖❖❖

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For example, a corporation that meets the asset requirement and files 200 Forms W-2 for employees and 49 Forms 1099-DIV, will be required to e-file its 2006 tax return.

Exempt organizations filing Form 990 are also subject to this requirement.

Private foundations and charitable trusts filing at least 250 returns will be required to e-file Form 990-PF beginning with the 2006 tax year. This requirement will apply to *all* private foundations and trusts regardless of assets.

The IRS will grant waivers only in extreme circumstances.

If yours is an affected corporation or exempt organization and you prepare your return in house, you must (1) register to e-file, (2) use IRS-approved software to facilitate electronic filing and (3) meet certain other requirements.

Failure to file electronically where required may result in penalties and interest.

As an authorized e-file provider, BKD can help you through this electronic filing process.

Early-retirement plan payouts demand decisions

Today, it's not unusual for people years away from retirement to suddenly find themselves with a lump-sum retirement plan payout of $50,000, $100,000 or more. Retirement is just one of many events that can trigger early distribution of retirement funds—changing jobs, being laid off or losing a job because of a merger or acquisition are just a few other examples.

If you receive an early distribution of your retirement plan funds, you'll have to make some important decisions about what to do with your money, and income tax considerations may play an important role in this process.

Immediate & full taxation - You can simply keep the cash and pay tax on the entire amount in the year of receipt.

Note: Where the distribution takes place before age 59½ , it may also be subject to a 10% early-withdrawal penalty in addition to income taxes; however, a number of exceptions apply to this penalty.

Rollover - Another alternative is to roll over the taxable portion of the lump-sum distribution to an individual retirement account (IRA) or to a new employer's eligible plan. No tax or penalty is generally due on the amount rolled over. A rollover can be accomplished two ways: 1) by instructing your old employer to directly transfer your balance to your IRA or new retirement plan or 2) by receiving your balance in lump sum and then contributing it to your IRA within 60 days of receipt.

The first option is usually the most attractive because it is much simpler and safer.

If you choose the second option, be careful; if you miss the 60-day deadline, you could be stuck with an unexpected tax bill. Your old employer will also be required to withhold 20% of your lump sum for federal taxes under this option.

While the withheld amount may be refundable to you when you file your tax return, you could be left in a situation where you need to make up the 20% withheld from other funds to make a full rollover by the 60-day deadline.

Determining the most favorable tax treatment is just the first step: This is a perfect time to reassess your investment options, especially if you roll your balance over to an IRA. Your IRA or new retirement plan may have significantly different investment options. You may want to consult your financial advisor on this issue.

Carefully think through your investment decisions. Because you may not need the money for retirement for another 10, 20 or more years, how you invest it and the annual investment return you earn can have a dramatic effect on the amount available at retirement.

Schedule M-3 filing requirements extended

During 2004, the IRS developed a new form intended to increase the transparency between reported net income for financial accounting purposes and reported net income for tax purposes. The result is Schedule M-3, Net Income (Loss) Reconciliation.

For 2004 returns, this form was required for corporations that file Form 1120 and had

Report large cash receipts to avoid penalties

If your trade or business receives more than $10,000 in cash in one transaction or in two or more related transactions, you must file a Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business*.

The definition of cash includes U.S. and foreign currency and can include cashier's checks, money orders, bank drafts or traveler's checks with a face amount of $10,000 or less. A business must file Form 8300 with the IRS within 15 days of the transaction.

Transactions that require Form 8300 include but are not limited to:

- Escrow arrangement contributions
- Pre-existing debt payments
- Negotiable instrument purchases
- Reimbursement of expenses
- Making or repaying a loan
- Sale of goods/services
- Sale of real property
- Sale of intangible property
- Rental of real or personal property
- Exchange of cash for other cash
- Custodial trust contributions

Laws passed by Congress require you to report these payments, and the *USA PATRIOT Act of 2001* increased the scope of these laws to help trace funds used for terrorism. Your compliance provides valuable information that helps law enforcement narrow its search for certain illegal money-laundering activities, but not all such transactions are presumed illegal.

Failure to file this form can result in hefty civil or even criminal penalties, even if the transaction is clearly legal. Forms are available at **www.irs.gov** or through your BKD advisor. ❖❖❖

assets of at least $10 million. For years ending on or after December 31, 2006, Schedule M-3 will also be required for S corporations with assets of at least $10 million and partnerships with assets of at least $10 million or total receipts of at least $35 million. In addition, certain other partnerships which are 50% or more owned by partners are required to file Schedule M-3.

The new schedule provides for a detailed reconciliation of book and taxable income. While taxpayers are already required to submit a similar schedule, Schedule M-3 requires a much more detailed reconciliation and will require more work from affected entities, especially in this year of implementation. **It is very important this schedule be carefully and accurately prepared because the IRS has already begun to use it to select audit targets.**

Tax exempts can use certain incentive programs

For-profit businesses routinely use incentive bonus programs for executives, salespersons and other employees because they are a great way to motivate employees to reach targeted goals. But what about tax-exempt organizations? Can they use incentive bonus programs?

An exempt organization must refrain from using its tax-exempt status for the benefit of organization insiders or risk significant punitive excise taxes or even revocation of its exemption.

In addition, compensation should be reported on the organization's Form 990, which is open to public scrutiny. Accordingly, exempt organizations sometimes walk a fine line between providing competitive and reasonable compensation and providing private inurement.

However, the IRS has ruled an exempt organization can adopt a long-term incentive bonus program under certain conditions:

- Make sure the compensation is for meeting specific goals that advance the organization's core tax-exempt purposes.
- Base the bonus amount on objective financial targets, such as return on capital.
- Use an independent board or committee to establish and oversee the program and determine eligibility and bonus amounts.
- Carefully document the performance of the eligible employees and the contribution to the core tax-exempt purposes.
- Give the committee the power to cancel or reduce the incentive compensation if it believes the plan would jeopardize the organization or its exempt-status or would otherwise not be in the best interest of the organization.

The independent committee should not be comprised of paid executives or officers of the organization, nor should its members be owners or key employees of companies that do business with the exempt organization.

Adequately compensating talented individuals can be tricky for exempt organizations, but following these rules of thumb can help.

Computing your business driving deduction

There are two basic methods of computing your deduction for business driving expenses: the standard mileage rate or the actual expense method. Which one is best? It depends.

Claiming standard mileage rate - When you claim the standard mileage rate, you don't separately deduct gasoline, oil, insurance, repairs and maintenance, depreciation or lease payments; however, parking and tolls are separately deductible.

Beginning January 1, 2006, the standard mileage rate went to 44.5¢ per mile. This rate is normally adjusted at least annually, but if your vehicle is a gas-guzzler and/or you do a lot of business driving, you may shortchange yourself if you use the standard rate to compute your deduction in a year when fuel prices continue to skyrocket.

Compare deduction - If you've kept the appropriate records, you may want to compare your deduction under both methods and use the one most favorable. You can switch from using the standard mileage rate one year to the actual expense method the next for the same vehicle. But you usually can't do the reverse.

Once you claim accelerated depreciation for a car under the actual expense method, the IRS won't let you compute your deduction for the same car using the standard mileage rate. ❖❖❖

Know basis in your investments

by Jim Laudick, jlaudick@bkd.com

Any time you sell an investment, you must report your capital gain or loss for tax purposes. To do that, you need to know your *basis* in the investment; subtracting your basis from the sale proceeds gives you the reportable gain or loss.

Determining basis can be simple or complicated, depending on how you acquired your investment and how much of it you sell.

For example, when selling stock or mutual fund shares that were purchased **at one time,** your basis is simply the total amount you paid for them. If you sell all your shares of a stock or fund that were purchased at different times, your basis is the total of the amounts you paid on the various dates. It's the partial sale of multiple acquisitions that is a little different, making calculating basis more complicated.

Such a sale includes shares acquired at various times *and* prices, like those purchased through a dividend reinvestment program or by reinvesting fund distributions.

And what about selling stocks? When you sell part of a stock position, you can use the specific identification (ID) method or first-in, first-out (FIFO) method. With specific ID, tell your broker **in advance** exactly which shares to sell by referencing the purchase date and per-share cost. This may let you reduce a taxable investment gain or increase a loss.

The FIFO method assumes you first sell the shares you've held the longest, which can produce a tax advantage in a declining market. If your oldest shares are the most costly, selling them first makes the most of your loss. (**Note: Tax law rules may restrict your deductible amount in the year of sale.**)

In a rising market, FIFO may work against you tax wise because it would increase your reportable gain if the shares acquired first have the lowest cost.

To compute your gain or loss selling

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Real assets: their role in investment

by J.R. Humphreys, BKD Wealth Advisors, LLC, ehumphreys@bkd.com

When the word "commodity" is mentioned in conversation, some may think of speculation in pork bellies or gold futures. However, commodities are the raw materials producers use to manufacture the goods we buy and the food we eat.

Adding commodities to a diversified investment portfolio of stocks and bonds provides several benefits for an investor, including positive returns over time and negative correlation to financial assets, such as stocks and bonds.

Basics & benefits of investing in commodities

The BKD Wealth Advisors approach to investing in commodities poses less risk than buying individual commodity future contracts. We invest in a mutual fund that tracks the Dow Jones American International Group, Inc. (DJ-AIG) Commodity Index, which provides exposure to a basket of commodities, including energy, livestock, industrial metals, precious metals, grains and food/fiber.

As an asset class, commodities have exhibited long-run positive returns that often equal or exceed the long-term returns of stocks with comparable risk. The returns of commodity indexes come from three major sources: spot returns, rebalancing returns and interest yield on collateral.

Commodity prices tend to rise over time. Many of us can remember $0.80-a-gallon gasoline and nice, four-bedroom houses that cost $70,000. Investing in commodities allows the investor to take advantage of this upward movement in prices of real assets, thus protecting their investment portfolio from inflation. In addition, recent demand from developing nations has driven the price of most commodities even higher.

Because BKD Wealth Advisors uses a fund that replicates the DJ-AIG Commodity Index, another source of return comes from the rebalancing of the sectors within the index. Commodities have a tendency to "mean revert."

For example, as corn prices go up because of demand for corn-based ethanol, more farmers will plant corn vs. other crops, such as soy beans. The result will be an increase in the supply of corn, which drives the price down towards its long-term average.

In the meantime, soy beans may go up in price as there are now fewer farmers planting them. Therefore, through active rebalancing, a commodity index can increase in value even if the sectors within the index do not gain in value over time.

How commodities stack up under real-world pressure

Another unique feature of commodity investing is the ability to earn interest on the collateral used to purchase the commodity future contract. Unlike equity investing, where money is exchanged for a share of a company, commodity futures are contracts that one need not pay for but maintains in an account for possible settlement.

With a risk/return profile similar to equity investments, investing in commodities on an

Market commentary:

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

As expected, the U.S. economy bounced back strongly in the first quarter of 2006, rebounding from the hurricane-depressed fourth quarter of 2005. Real gross domestic product (GDP) growth for the first quarter came in at 5.60%. This exceptionally strong growth will not be sustained but does serve to bring the average pace of growth back in line with recent trends.

Preliminary indications are that second-quarter growth moderated to the 2.5% to 3% area. Decelerating housing activity, increasing energy costs and higher interest rates are combining to pull growth down toward the longer-run real GDP trend rate of 3%.

These factors have disproportionately affected lower-income households that spend a combined 18% of income on gas and housing, two categories that have increased at a pace well above the overall rate of inflation.[1] By comparison, high-income households spend only 5% of income in these categories.

The Federal Open Market Committee continued to be active in the quarter, raising the Federal Reserve (Fed) Funds rate by .25% at both its May and June meetings. This brings the current Fed Funds rate to 5.25%.

Before the Fed's May meeting, many in the investment community thought the rate-hike cycle would end at a 5% funds rate. However, Fed commentary during and after this meeting was seen as very hawkish towards inflation, meaning further rate increases were probable.

This proved to be the case, as the Fed moved rates up again in June. The future market currently implies a higher than 50% chance the Fed will bring rates up again at the next meeting in August.

The economic impact of Fed rate increases is lagged, and we now have more than two years' worth of tightening in the pipeline. In addition, with oil prices reaching all-time highs in nominal terms at over $75 per barrel, the risk of growth sinking below 3% later this year and into 2007 is rising. From here, each incremental Fed rate increase is likely to further deteriorate the growth outlook for 2007.

Equity markets

During the second quarter, trading activity abruptly shifted from a positive to a negative tone. The markets hit new highs for the year in early May, continuing the strong start experienced in the first quarter.

Then came the May 10 Fed meeting, when it became clear interest rates would move higher. This was unexpected by equity investors and caused future economic and profit growth expectations to be reset to lower levels. Therefore, the major U.S. equity indices declined in the second quarter, though they

portfolios

individual basis looks attractive, but the strongest argument for adding a commodity index to your investment portfolio is the negative correlation commodity returns have with traditional stock and bond returns.

Correlation is a statistical measure of how two securities move in relation to each other. Negative correlation means the security returns move in opposite directions. Economic conditions that are good for commodity returns, *e.g.*, unexpected inflation, are often bad for stocks and bonds. This analogy is also relevant to geopolitical conditions: Middle Eastern conflict or a natural disaster may disrupt oil supplies and lead to higher gasoline prices. This is bad for stock and bond returns but positive for commodity index returns.

For example, in the second quarter of 2006, the return on equity and fixed income investments was negative. This was attributed to (1) the specter of inflation, (2) the need for additional rate increases by the Federal Reserve and (3) higher oil prices. However, what was bad for equity returns was good for commodity returns: The DJ-AIG Commodity Index gained 3.3% for the second quarter.

* * *

Consider adding indexed commodity investments to your traditional stock and bond portfolios. While the long-term returns on commodities are similar to those of stocks with similar risk, the greatest benefit comes from the shock-absorbing effect commodities have when economic forces batter your equity and fixed income investments. ❖❖❖

is strong growth sustainable?

still remain positive for the year.

Large-cap stocks outperformed mid-cap and small-cap stocks during the quarter; however, to date in 2006, large companies continue to lag. International stocks held their own during the period, primarily because of a weakening U.S. dollar. In local currency terms, developed foreign markets have posted returns very similar to the S&P 500 for the year, but the weakening dollar amplified them to nearly four times the S&P 500's gain.

The emerging-markets segment of the international market declined about 5% during the quarter and fell nearly 20% from the peak of early May, as investors took gains and pulled money from riskier asset classes. Also, many emerging economies are extremely levered to the U.S. consumer, who represents the major buyer of the goods they produce. Therefore, weakening U.S. consumption trends are also of concern in the global economy.

After two years of largely range-bound trading in U.S. stocks, the market has begun to exhibit a more normal level of volatility in the last several months. To some investors, recent trading activity has seemed extremely volatile, particularly when compared to the very subdued environment in 2004 and 2005. However, from a historical standpoint, the fluctuation in stock prices so far in 2006 is normal.

As the Fed deals with the complicated task of transitioning the economy from recovery to sustainable growth with modest inflation, recent levels of volatility are likely to persist.

Fixed income markets

The state of the bond market in the second quarter was largely unchanged from the previous quarter. Rising interest rates continue to cause minor declines in bond prices, largely offsetting coupon income, a dynamic that has caused total bond returns to be flat for the second quarter.

Year to date, the Lehman Municipal Index has posted a total return of .28% and the Lehman Aggregate Index of taxable bonds has declined slightly, by .72%.

So far in 2006, Treasury yields have risen about .75% across the maturity spectrum. As long as interest rates continue to rise, the ***total returns*** posted by bonds will be weak. However, yields on new bond investments are at the highest levels in about four years, increasing the likelihood of better total bond returns going forward.

Investment outlook

Current economic and corporate earnings growth continues to impress. Both will likely have moderated to some degree in the second quarter. We anticipated the Fed would end the current tightening cycle during the first half of 2006, allowing stock prices to rise in recognition of the strong growth in profits and a sustainable pace of growth in the economy.

Current information suggests the Fed may raise rates further. A deeper and more protracted slowdown in the U.S. economy becomes more likely with each additional Fed move from here.

At 15 times current-year earnings and 14 times expected 2007 earnings (S&P 500), our belief is stocks represent good value. However, an end to the contraction in the market multiple, or a modest expansion, will be delayed until investors are convinced the future growth prospects of the economy have not been severely affected by Fed actions.

We continue to believe the end of the tightening cycle is near. Until then, the Fed's stance will continue to trump corporate profit performance as the primary driver of stock prices. Ultimately, a more stable interest-rate environment and inflation outlook should allow both stock and bond performance to improve. ❖❖❖

[1] **Source:** Department of Labor, Goldman Sachs

Know basis in your investments. . .

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mutual fund shares, first determine your tax basis (the amount you paid for the shares you sold). If you acquired your mutual fund shares over many years, through periodic investments or a dividend reinvestment plan, calculating your basis could be complicated.

The four basis calculation methods for selling fund shares acquired at different times include:

- Single-category average basis
- Double-category average basis.
- FIFO (You must use FIFO unless you meet the conditions for another method.)
- Specific ID

Average cost per share is the easiest and most commonly used method—you simply average the cost of all the shares you purchased.

Example: You purchased 700 shares of a mutual fund over three years and have paid a total of $4,200 for all of them. If you sell 300 shares for $10 each ($3,000 total), your basis per share is $6 ($4,200 divided by 700). Your gain per share is $4.

Once you use the single-category method for a fund, you must use it for all future sales of that fund's shares. To use the double-category method (average cost per share/multiple categories), separate your shares into long-term (held more than one year) and short-term groups.

Calculate the average per-share basis for each, then assign the shares you sell to either category to secure the most favorable tax treatment. Instruct the fund company or your broker **in advance** about how many shares to sell from each category. Remember, if you use the double-category method once, you must use it for all future sales of the same fund.

With FIFO, shares purchased first are considered the first sold. Your tax basis is the actual price you paid for the shares you sold. If your fund has risen since you began buying, this method may result in the largest amount of gain on the shares you sold.

With specific ID you identify the specific shares you are selling. It's the most flexible method because you can choose the shares with either the lowest or highest basis, as best suits your tax need.

Example: Let's say you purchased your fund shares in four lots (groups) of 100 shares. Lot number one cost $2,000. Lot number two cost $2,500. Lot number three was $1,500, and the most recent lot cost $1,700. Your sale is 100 shares for $1,900. By selling lot number two, you increase your reportable *loss*. By choosing lot number three, you increase your reportable *gain*, which could help offset losses.

Support all four methods with accurate records. Keep your transaction confirmation statements that show the purchase date, number of shares and the price; you'll need this information when you sell shares. With most funds, you also receive a summary annual statement (a record of the year's transactions).

Finally, be aware of the following mutual fund tax information:

- Include in your basis calculation any reinvested capital gains distributions and dividends, as well as any sales loads.
- Calculate the cost basis differently in each of your funds, but once you use a method for a fund, you'll need IRS permission to change it for that fund.
- A taxable event occurs whenever you switch money among funds, even if the funds are part of the same fund family. The IRS also considers any check you write against a mutual fund to be a sale of your shares.

The best time to consider your basis options is **before** you sell securities. Your planning efforts should pay off when tax-filing season arrives. ❖❖❖

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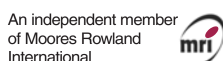

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