BKD Advisor

Beyond Your Numbers

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Information to Help You Make Smart Business & Financial Decisions

Research credit extended, method simplified

The federal tax credit for increasing research activities (research credit) will continue to reward U.S. companies for developing new products and business processes. The credit is targeted to businesses that pay or incur amounts for in-house and contract research expenses for the purpose of discovering information that is technological in nature.

Research that involves the social sciences, arts or humanities or is conducted outside the U.S. doesn't qualify, nor does contract- or grant-funded research. The credit can be highly beneficial to qualifying taxpayers, but it has expired and been extended 12 times since its 1981 inception. It expired again at the end of 2005, but the *Tax Relief and Health Care Act of 2006* (TRHCA), signed into law in December, extends it and several other tax provisions that expired at the end of 2005 or were set to expire at the end of 2006.

TRHCA retroactively extends the research credit to amounts paid or incurred after December 31, 2005, and before January 1, 2008. Taxpayers who qualify for the credit may claim it on their 2006 tax returns, and those who discover they are eligible for the credit but have not claimed it may file amended returns for refunds. In addition to the extension, TRHCA adds a new alternative simplified credit for tax years ending in 2007. (Again, the research credit is set to expire after 2007 unless it's extended as it has been in the past.)

The alternative simplified credit equals 12% of the qualified research expenses for the taxable year that exceed half the average qualified research expenses of the three preceding taxable years. If the taxpayer lacks qualified research expenses in any of the three preceding taxable years, the credit will equal 6% of the total qualified research expenses for the taxable year.

The new simplified credit is not mandatory—taxpayers can still use the regular method or may elect instead the alternative simplified credit. However, once elected, the simplified credit applies to **all** succeeding taxable years unless revoked with IRS consent.

This credit is anticipated to have a significant impact on the value of available credits for start-up companies (those that did not have qualified research expenses from 1984 through 1988). The standard research credit calculation typically precludes start-up companies from claiming a meaningful credit.

New alternative fuel credit: are you eligible?

If you use certain alternative fuels to power a "motor vehicle" (see definition below) or boat, you may be eligible for a new federal tax credit, which may be especially lucrative for businesses that use propane-powered forklifts.

Beginning October 1, 2006, you may be eligible for a 50 cents-per-gallon federal tax credit if you use alternative fuel, or a mixture containing alternative fuel, in a motor vehicle or motorboat (collectively, "vehicle").

For this purpose, the term **alternative fuel** does **not** include ethanol, methanol, biodiesel or renewable diesel, as similar credits are already in place for these fuels. Instead, it refers to:

- Propane
- Natural gas
- Liquid hydrogen
- Liquid fuel derived from coal
- Certain fuels derived from biomass
- P-Series gasoline alternatives

Also for this purpose, **motor vehicle** refers to all types of motor-propelled vehicles designed to carry or tow loads, whether registered for highway use or not. This includes forklifts but excludes farm tractors, trench diggers, power shovels, bulldozers, road graders, rollers and similar equipment that does not carry or tow a load.

The retail seller of the fuel may claim the credit if (1) the seller directly fills the fuel tank of the vehicle or (2) the sale is in bulk, and the buyer certifies the fuel will be used entirely for a taxable purpose.

The buyer may claim the credit if (1) the sale is in bulk and (2) the buyer has not certified the fuel will be used entirely for a taxable purpose. To claim the credit:

- Register as an alternative fueler and obtain an alternative fueler number (AFN) from the Internal Revenue Service (IRS) by filing Form 637, *Application for Registration for Certain Excise Tax Activities*. The IRS may conduct a site visit and might not issue an AFN to taxpayers that aren't in compliance with federal tax rules.

continued on page 2

What's inside:

- **Page 4 -** ***Foreign earned income exclusion requires basic tax planning***
- **Page 5 -** ***Demand drives current M&A boom market***
- **Page 6 -** ***Market commentary: recent data suggests economy on track for soft landing***
- **Page 8 -** ***BKDWA professionals cultivate authoritative media presence***

The alternative simplified credit should remove barriers that kept start-up companies from claiming meaningful credits. Further, it can benefit nonstart-up companies that lack documentation from 1984 through 1988 by eliminating the need to examine several past years and allowing companies to focus on the current year and the three previous years.

The extension and enhancement of the research credit is a victory for manufacturers, software developers and others involved in research and development activities. Many companies haven't claimed the credit in recent years because of the standard credit calculation, but the simplified credit may allow them to reevaluate their eligibility.

You can't avoid AMT even if you forego deductions

From 2003 to 2004, government statistics revealed 700,000 more taxpayers were subject to the alternative minimum tax (AMT), an increase of 31%. The AMT continues to affect more individual taxpayers every year because its exemption amounts are not indexed for inflation, and, while regular income taxes have been cut, the AMT has not.

To reduce AMT, one planning strategy recommends taxpayers forego certain itemized deductions, *e.g.*, state taxes and miscellaneous itemized deductions not allowed for AMT. Depending on the situation, this can reduce AMT and one's overall federal tax liability, but, according to a recent case ruling by the Federal Court of Appeals, this strategy doesn't work.

The case involved a wage earner with adjusted gross income (AGI) of $67,000, miscellaneous itemized deductions of $26,000 and an eligible state tax itemized deduction of $10,000. Large itemized deductions for state taxes and miscellaneous expenses are a recipe for AMT and, the taxpayer would have had AMT had she not foregone $5,000 of her state tax deduction.

When the IRS examined this treatment and challenged it, the taxpayer took the IRS to court. In the end, though, the court ruled the taxpayer could not forego the deductions and had to pay the AMT.

IRS releases 2006 FYE enforcement statistics

The IRS has released enforcement-related statistics for its September 30, 2006, fiscal year end (FYE). Though exam activity bottomed-out in 2000, it has since grown steadily as more resources have been allocated to enforcement. With 2006 activity nearing 1999 levels, the IRS promises future exam activity will continue to increase as more audit personnel are trained.

There are basically two types of IRS audits of individuals: field and correspondence. Field audits are typically conducted face to face by IRS agents in an IRS office, at the taxpayer's location or in the tax advisor's office. Correspondence audits are conducted through the mail and are typically less comprehensive than field audits.

Field audits of individuals increased noticeably, as did audits of high-income individuals. Audits also increased significantly for S corporations, partnerships, exempt organizations and C corporations with assets between $10 and $50 million.

Individuals

- Audits of individual returns were up 6.5%.
- Of the individual tax returns filed between October 1, 2004, and September 30, 2005, 0.23% were subject to a field audit, and 0.75% were subject to a correspondence audit; field audits increased 22% over the previous year.
- Audits of individual taxpayers with incomes of $1 million increased 33%; of these returns, 2.8% were audited by correspondence, and 3.5% received field audits.
- Audits of individual taxpayers with incomes between $100,000 and $1 million increased 17%; of these returns, 0.9% were audited by correspondence, and 0.7% received field audits.
- Audits of individual taxpayers with incomes under $100,000, the number of audits increased 4%; of these returns, 0.07% were audited by correspondence, and 0.02% received field audits.

Businesses

- The number of S corporation audits increased 34%; of these returns, 0.38% were audited.
- The number of partnership audits increased 15%; of these returns, 0.36% were audited.

New alternative fuel credit . . .

continued from page 1

If you are liable for the excise tax on fuel (or any other federal tax) and have not paid it, you may have to correct noncompliance before the IRS will issue your AFN.

- Claim the credit against your excise tax liability on alternative fuel on Form 720, *Quarterly Federal Excise Tax Return*. (Generally, 18.3 cents per gallon for propane and P-Series fuel; 24.3 cents per gallon for other alternative fuels.)
- Your business may claim the remainder up to a total credit of 50 cents per gallon on its income tax return. The credit is refundable, so it is not limited to income tax liability.
- To back up your credit claims, document the amount of alternative fuel purchased and used and who you bought it from.

If you were eligible but did not claim the credit on a previously filed Form(s) 720, you can file an amended return(s) to request a refund.

If you use an alternative fuel for a nonbusiness vehicle, you may only use the credit to offset the excise tax. **You may not claim the excess refundable credit on your tax returns.**

If you power forklifts with propane, you will likely claim the entire 50 cents-per-gallon credit on your income tax return because fuel used off-highway is generally exempt from excise tax; thus, there is no tax liability for this fuel on Form 720.

In this situation, the buyer, not the seller, is eligible for the credit unless the seller delivers the fuel directly into the tanks of the buyer's forklifts.

Additional information must be disclosed if the credit is claimed for a fuel mixture containing alternative fuel.❖❖❖

- Audits of exempt organizations increased 43%, and 7,079 of these returns were audited.
- For C corporation taxpayers with assets under $10 million, the number of audits was unchanged; of these returns, 0.8% were audited.
- For C Corporation taxpayers with assets between $10 and $50 million, the number of audits increased 19%; of these returns, 14.2% were audited.
- For C Corporation taxpayers with assets between $50 and $100 million, the number of audits decreased 13%; of these returns, 13.8% were audited.
- For C Corporation taxpayers with assets between $100 and $250 million, the number of audits decreased 16%; of these returns, 14% were audited.
- For C Corporation taxpayers with assets of $250 million or more, the number of audits decreased 12%; of these returns, 35.3% were audited.

New charitable giving rules will affect individuals

Taxpayers are generally required to substantiate or prove their tax deductions, and special substantiation rules have historically applied to charitable contribution deductions; however, taxpayers were not required to get receipts for cash donations of less than $250.

Beginning in 2007 under the *Pension Protection Act of 2006* (PPA), taxpayers must have a bank record or a written receipt from a charity to deduct monetary donations.

If you donate by check or credit card, keep copies of canceled checks, bank or credit union statements and credit card statements. These records should show the name of the charity and the date and amount donated. Credit card statements should show the name of the charity and the transaction posting date.

If you've traditionally made cash donations in small amounts, get a receipt from the charity showing the amount and date of the donation. Where practical, write a check instead of giving cash, so you'll have a bank record and won't need a receipt from the charity. One rule has not changed: Charitable organizations must provide donors a written acknowledgement for donations of $250 or more.

Telephone tax refund formula simplified

As covered in earlier **BKD Advisor** editions, the IRS concedes when a telephone communication's toll charge varies only with elapsed time and not distance, it is not subject to the 3% federal telephone excise tax. Accordingly, refunds are available for amounts paid for long distance service billed to taxpayers after February 28, 2003, and before August 1, 2006.

Late November 2006, the IRS provided a formula businesses (including sole proprietors, trusts and estates) and tax-exempt organizations may use to estimate their telephone excise tax refunds.

Without this provision, businesses and exempt organizations would need actual bills to calculate their refunds, so, instead of compiling old bills, they can now calculate refund amounts by comparing two telephone bills to determine the percentage of their expenses attributable to the long distance excise tax.

If this affects your business or organization, figure the telephone tax as a percentage of your April 2006 and September 2006 telephone bills first and apply the difference between these two percentages to your quarterly or annual telephone expenses to determine the amount of refund.

For businesses and tax-exempt organizations with 250 or fewer employees, the refund is capped at 2% of the total telephone expenses. It's capped at 1% for those with more than 250 employees. Alternatively, telephone expenses can be estimated based on reported business-related telephone expenses on tax returns for tax years 2003 through 2006.

Supporting orgs face strict PPA provision compliance

Signed into law August 17, 2006, the *Pension Protection Act of 2006* (the Act) provides strict new rules for supporting organizations—organizations whose purpose is to raise funds for public charities. Supporting organizations can be one of three types:

Type I - operated, supervised or controlled by the supported charity

Type II - supervised or controlled in connection with the supported charity

Type III - operated in connection with the supported charity

The Act provides the following:

- A Type I or Type III supporting organization will lose its public charity status if it accepts a contribution from a person who directly or indirectly controls a supported charity. As a result, supporting organizations may elect to decline all contributions offered by anyone connected with a supported charity.
- Private foundations will no longer receive "credit" toward their qualifying distribution requirements for grants paid to most Type III supporting organizations. As a result, very few private foundations will make grants to Type III supporting organizations. The same limitations will apply to grants paid by a private foundation to a Type I or Type II supporting organization if a disqualified person of the private foundation controls the Type I or II supporting organization.
- Any grant, loan, compensation or similar payment from a supporting organization to a substantial contributor or a related party is an automatic excess benefit transaction subject to substantial excise tax penalties.
- The U.S. Treasury will conduct a study to consider whether tax deductions should remain available for contributions to all supporting organizations.

Other miscellaneous provisions of the Act (1) subject Type III and Type II supporting organizations to the excise taxes on excess business holdings, (2) ban Type III supporting organizations from supporting foreign charities and (3) increase payout requirements for Type III supporting organizations.

If your entity is a supporting organization, take immediate steps to understand the new rules. The Act may require you to decide whether to comply with the new rules or restructure to avoid classification as a supporting organization.

Some supporting organizations may decide to restructure to qualify as a more favored organization. Failure to adequately address these rules may result in reduced donations, penalty taxes or even revocation of tax exempt status.

Private foundations should also pay attention to these rules to avoid potential taxes and penalties. ❖❖❖

Foreign earned income exclusion requires basic tax planning

by Greg Cislak, gcislak@bkd.com

Like the tax residents of most foreign countries, U.S. citizens and residents are also taxed on their worldwide income. Thus, American taxpayers may be taxed by both the U.S. and a foreign country.

That said, the U.S. tax code, foreign tax laws and numerous U.S. tax treaties permit several opportunities to avoid or reduce "double-taxation" of income, but planning is vital.

U.S. tax code provides credits, exclusions

The U.S. tax code provides two significant opportunities to reduce U.S. taxation of foreign income: the Foreign Tax Credit (Section 901), which applies to income from foreign sources, and the Foreign Earned Income and Housing Exclusion (Section 911), which requires the separation of passive and nonpassive foreign income before the foreign tax credit can be calculated for each type of income.

The amount of foreign tax credit you may take on your U.S. return is the *lesser* of the following:

- The actual foreign taxes paid (or accrued) during the tax year
- The actual U.S. tax liability on the foreign income

An excess foreign tax credit may be created if the foreign taxes paid or accrued are more than the U.S. tax liability on the foreign income. The unused credit can be carried back one year or carried forward 10 years to offset foreign income in those years.

Since 1926, the U.S. tax code has permitted individuals who live and work outside the U.S. to exclude a portion of their wages (and foreign housing costs) from U.S. taxation, known today as the Foreign Earned Income and Housing Exclusion.

To elect this exclusion, complete Form 2555 (or Form 2555 EZ) and attach it to a tax return for the first tax year the election applies. You must meet certain requirements to qualify for the election, including:

- Your "tax home" must be in a foreign country. Generally, this means your main permanent or indefinite place of business or employment is in a foreign country, though it's still possible for your vacant "family" home to be in the U.S.
- If you have a tax home outside the U.S., you must meet either the *bona fide foreign residence* test or the *foreign physical presence* test.

To meet the *bona fide foreign residence* test, you must be a bona fide resident of one or more foreign countries for an uninterrupted period that fully covers at least one tax year. Broadly speaking, a taxpayer is a bona fide resident if he/she intends to live in a foreign country for the time being, even while intending to eventually return to live in the U.S. In addition, brief, temporary trips back for vacation or business will not cause the taxpayer to fail this test.

To meet the *physical presence* test, you must be physically present in a foreign country for 330 full days during any period of 12 consecutive months. For this test, the months do not have to cover an entire tax year—for example, they can run from June through May.

If you meet either test, a maximum of $82,400 in 2006 ($85,700 in 2007) of foreign earned income can be excluded from taxable income. If you do not satisfy the tests for the entire year, the limitation is computed on a daily basis. In addition, on jointly filed returns, you and your spouse can each claim the exclusion; the amount of the exclusions is determined separately.

Note: The foreign earned income exclusion is elective, not automatic. If the exclusion is elected, a tax credit for foreign taxes paid on the excluded income cannot be taken. Thus, compare the tax savings of the exclusion with those of a credit.

If an employer covers all or part of your foreign-housing costs, it may be possible to qualify for the foreign-housing cost exclusion; however, this may reduce the foreign earned income exclusion in some cases. Recently enacted legislation now limits the amount of foreign-housing expenses you can deduct on Form 2555.

The U.S. has income tax treaties with more than 80 countries, which often contain provisions that permit U.S. taxpayers to avoid income taxation by the treaty country provided the taxpayer works in the treaty country for less than 183 days during the year.

Because these treaties are not identical, we recommend a close review of the treaty and your specific situation before determining how much of your income can avoid foreign taxation.

Also, many treaties provide special provisions to reduce or eliminate "double taxation" for U.S. taxpayers who are required to pay tax in the treaty country. For reference, IRS Publication 901, *U.S. Tax Treaties*, provides a good summary of U.S. tax treaties. ❖❖❖

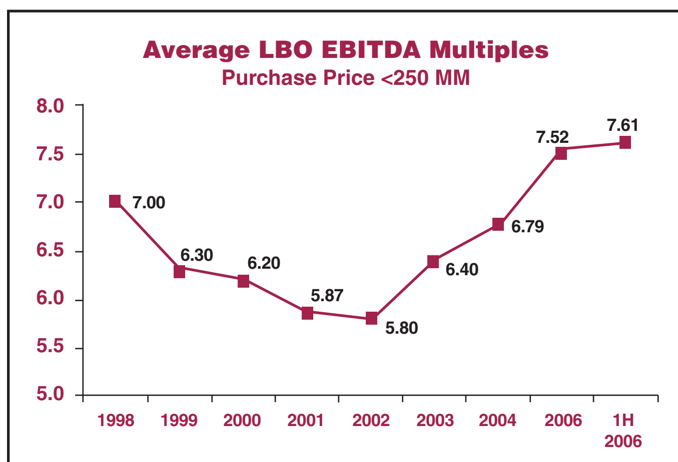
Demand drives current M&A boom market

by Troy Prewitt, Vice President, BKD Corporate Finance, LLC, tprewitt@bkd.com

By any measure, 2006 was a boom year for mergers and acquisitions (M&A), with both acquisition prices and deal flow at their highest levels in five years.

According to Standard & Poor's, leveraged buyout transactions of less than $250 million traded at an average of 7 to 7.5 times EBITDA (earnings before interest, taxes, depreciation and amortization) in 2006 compared to 5.8 times in 2002. With the start of a new year, our clients are asking about the health of the M&A market in 2007.

While we believe market fundamentals are in place for a strong 2007, we're starting to hear predictions of when this bull market will cycle down. Predicting the end to any cycle is easy. If a prediction is made early enough, it will eventually be correct: It's said a well-known economist once successfully predicted 24 of the last two recessions.



Timing, a critical component

It's simply impossible to consistently and accurately predict the timing of market cycles. Money managers who subscribe to Modern Portfolio Theory (MPT) believe their empirical evidence proves market timing is a detriment to portfolio performance.

Nonetheless, timing can be a critical component of business value. It's possible for a bad business to sell for more during a boom cycle than a good business in a down cycle.

The most common timing pitfall is trying to time the peak of the market. When we talk about market timing, we're simply talking about an awareness of market conditions and a preparedness to act when the time is generally favorable.

In our experience, those who try to optimize their exit timing often end up missing the mark. On Wall Street, it's said there is a market for the bulls and a market for the bears, but the pigs always get slaughtered. So how do you know when the time is right?

Current supply & demand

Ultimately, supply and demand determine pricing. A fundamental shift in either the supply or demand curve will shift equilibrium pricing and mark the beginning of a new cycle. Let's take a closer look at the current supply and demand fundamentals and how they may shape the market in 2007.

Demand for businesses is driving the current M&A boom market. Cash-rich private equity groups (PEGs) are competing with strategic corporate buyers for the available inventory of businesses for sale. Since 2000, PEGs collectively raised more funds than they have deployed, creating a capital overhang as high as $150 billion and placing them in a position of either deploying capital or returning it to investors.

As a result, PEGs have been collectively very aggressive in the first two years of this cycle; however, time has a way of catching up. During the final quarter of 2006, the situation reversed: As a community, PEGs now deploy more capital than they can raise.

This should affect demand for acquisition targets, but it's too early to forecast if it will cause a meaningful shift in the demand curve. Because PEGs continue to generate impressive risk-adjusted returns for institutional investors, capital should continue to flow to the sector but perhaps not as fast.

Acquisition capital & global M&A activity

As for strategic corporate acquirers, corporate balance sheets are very healthy and should remain so during 2007. They are flush with acquisition capital as a result of cheap debt, a strong stock market and strong cash positions.

In addition, many experts believe corporations integrate acquisitions better today than ever before. Nothing shuts down a corporate M&A deal-shop faster than a couple of underperforming acquisitions. Conversely, acquisitions that perform to pro forma can generate a growth-through-acquisitions feeding frenzy.

We're also keeping a close eye on two additional sources of acquisition capital: unregulated hedge funds and cash pooling in India and China. We know hedge funds have participated in buyout transactions in the past and will continue to do so, but we don't know if they'll commit to the sector sufficiently enough to move the demand curve.

As for India and China, globalization requires consolidation, and both countries are better positioned than ever to participate in global M&A. We'll continue to monitor both subjects for 2008 and beyond.

Boomers' effect on supply side

On the supply side of the equation, we believe a steady, linear supply of businesses will come to market during 2007, keeping demand and supply in relative equilibrium. However, on the mid-term horizon, baby boomers and taxes are two fundamental changes that could affect the supply side beginning at the end of 2007, and we're advising our clients accordingly.

The front end of the boomer generation will start retiring next year. This generation holds roughly $10 trillion in wealth, with the vast majority of it held as stock in closely held corporations.

Many experts predict baby boomers will transfer ownership of roughly 8.3 million businesses over the next 10 to 15 years. Regardless of their exit channel, they will compete for available acquisition capital. We

continued on page 8

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Market commentary: recent data suggests

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

Real economic growth continued to slow during the last two quarters of 2006. Revised third-quarter growth was reported at 2%, and expectations are very similar for the final quarter of the year. Although economic growth for the full year of 2006 will likely end up at the trend rate of about 3%, there was clearly a deceleration in the second half, as the cumulative effect of two years of Fed tightening took hold.

Economic environment

At this point in the cycle, some slowing is expected as the Federal Reserve (Fed) attempts to maneuver the economy toward a sustainable pace of growth, while keeping inflation contained. Recent data would support the idea these objectives are being met and that our economy is on track for a "soft landing." Falling energy prices have helped the cause on two fronts, allowing for stronger consumer spending and also creating downward pressure on inflation.

Consumers account for two-thirds of all spending in the U.S. Given their importance to the economy, consumer financial health was heavily scrutinized in 2006. The dramatic slowdown in housing activity during the year caused many to believe the consumer would retrench, particularly because home sales and mortgage equity withdrawal have been such large contributors to spending in recent years.

However, a solid employment picture, retreating fuel prices and declining market interest rates combined to give consumers a boost, resulting in good gains in consumption during the important holiday selling season and for 2006 as a whole.

Although the Fed has not officially indicated its current mode is "neutral" as to future interest rate changes, the central bank's actions (or lack thereof) would imply this. The minutes from the most recent Fed meeting on December 12 indicate a concern for downside risk to economic growth, but "inflation risks remained of greatest concern and additional policy firming was possible."

Given current information, we do not expect the Fed to raise rates again soon, as both growth and inflation appear to be moderating to acceptable levels. However, given solid employment trends, reasonable financial conditions and decent economic performance at this stage in the cycle, we are not yet convinced the Fed will ease significantly in 2007, as many economists have speculated.

The timing and direction of the Fed's next move will become clearer as the rate hikes of the past two years work their way through the economy in the first half of 2007.

Equity markets

U.S. stocks rose significantly in the fourth quarter of 2006, and many major equity indices finished the year at new all-time highs. This rally began last August, prompted by two catalysts: the Fed's decision to "pause" and a moderation in energy prices.

These positive factors persisted in the final quarter of the year, with an additional spark coming in the form of exceptional earnings growth. With three quarters of 2006 results already on the books, consensus estimates for S&P 500 earnings growth are in the area of 15% for the full year, well ahead of earlier expectations.

This is the first year in the last three that share prices have risen commensurate with the pace of earnings growth, meaning P/E multiple contraction has ended, at least for now.

Equity Index Returns	4Q 2006	2006 YTD
S&P 500	6.70%	15.80%
S&P Mid-Cap 400	6.98%	10.32%
Russell 2000	8.90%	18.37%
MSCI EAFE	10.35%	26.34%

An analysis of the historical relative valuation between large-cap and small-cap stocks would indicate the extended period of small-cap out-performance should soon end. The differential is particularly significant in the small-cap value style vs. the large-cap growth style comparison. Despite this, small-company shares once again outpaced the returns of large-cap stocks in 2006.

Attractive relative valuation levels—as well as the traditional tendency for companies that produce more consistent earnings growth to lead the market at this stage of the economic cycle—cause us to believe large-cap growth stocks are currently the most attractive segment of the U.S. stock market.

The November mid-term election results caused a brief sell-off in equities the day the results were posted, but the market quickly recovered to hit new highs through the remainder of the year. The Democratic control of Congress was not initially well received by the investment community. However, for issues that matter most to investors (estate taxes, dividend tax rates, capital gain tax rates, etc.), the assumption now is that the more important election will be in 2008 because current legislation on these issues doesn't sunset until 2010.

International stocks in both the developed and emerging markets posted another very good year of results for U.S. investors. The depreciating dollar gets most of the credit for the outperformance of the MSCI EAFE index (up 26% in 2006). Looking at the same basket of stocks in local currency terms would reveal a return of 16%, similar to U.S. stocks.

economy on track for soft landing

In summary, the absolute returns posted by equities around the globe were very good in 2006, with the result being the best year for stocks since the "rebound" year of 2003. Another distinguishing characteristic of the 2006 market is that active managers generally lagged passive index returns.

According to Goldman Sachs, roughly 85% of U.S. equity managers underperformed their respective benchmarks during the year. Low dispersion of returns across economic sectors is one reason for this, as active managers had difficulty generating excess return by making sector bets. But the same broad-based-advance characteristic has positive implications for the sustainability of the current rally, as rallies that are narrow in focus tend to be less viable.

Fixed income market

Ten-year Treasury bond yields declined from the late-June peak of 5.25% to a second-half low of 4.42% at the beginning of December, as bond investors began to expect the Fed would ease some time in 2007, and inflation concerns abated. The yield climbed back to 4.71% by the end of December, with the economic data released during the month proving better than anticipated. For the full year, the bond rose in yield by about 0+0.30%.

Total bond returns were flat during the first six months of the year, as rates rose to their peak in late June. The second half was much better, as yields retreated and bonds gained back some of the principal value lost in the first six months of the year.

When all was said and done, the Lehman Aggregate index gained 4.33% during the year, while the Lehman Municpal index was up 4.84%. Although not a stellar year for bonds, principal values have stabilized, allowing more of the coupon yield of the bonds to flow through to total return.

Corporate-yield spreads, both investment-grade and high-yield, remain historically narrow vs. current Treasury yields. To the investor, this means the return premium received for taking additional risk is low (particulary in the high-yield area). This may reflect a relatively strong global economy, as well as the global search for yield.

Government bond yields are relatively modest in most parts of the world. With spreads this narrow, the "margin for error" is small, meaning there are more than normal levels of risk in these bond investments.

Investment outlook

As detailed in our fourth-quarter 2005 report, our thesis entering 2006 was we would see S&P 500 earnings growth in the 8% to 10% range that year. We also anticipated the Fed would conclude the tightening cycle in the first half of the year, allowing the market price-to-earnings multiple to expand from 16 to 17. The net result of upper single-digit-earnings growth and slight multiple expansion was a stock market return expectation of 15%.

As it happened, the actual S&P 500 return came very close to this expectation in 2006; however, the source of the return was surprisingly strong earnings growth with no real expansion in the P/E multiple. Corporate earnings growth also exceeded expectations throughout the year. Because earnings grew at roughly the same pace as stock prices in 2006, the P/E multiple of the market held steady at 16 times, a very reasonable valuation in our view.

With economic growth slowing in the U.S., corporate earnings growth will also slow. Current consensus estimates indicate S&P 500 earnings growth of 9% in 2007, down from the double-digit pace of recent years. Even with a deceleration in earnings growth, the coming year should be another good one for stocks, particularly if the Fed becomes more concerned about economic weakness than inflation and begins to ease.

Given the current levels of interest rates and inflation, we believe stocks are worth 17 to 18 times earnings. If the market multiple were to expand to these levels, we would expect upper-teens equity returns in 2007. In the absence of Fed easing, multiple expansion is less likely, limiting equity returns to the upper single-digits, in line with expected earnings growth.

Given the large U.S. trade deficit and the topping out of interest rates here, most analysts expect the dollar to continue to weaken moderately in the coming year. Combined with the expectation that strong global growth will persist in 2007, the environment for international stocks should be positive. U.S. companies with a large percentage of international sales will also benefit.

With a stable interest rate environment expected in 2007, bonds should provide coupon-like total returns. Although mid-single-digit returns pale against recent equity results, bonds will still play a crucial role in portfolio diversification and income production.

The world we live in can change rapidly without notice; therefore, maintaining an appropriate asset allocation is crucial to investment success. ❖❖❖

Turn to page 8 for special coverage of BKD Wealth Advisor's growing national media presence and how it benefits you.

BKDWA professionals cultivate authoritative media presence

by BKD Staff Writer

Last spring, Jeff Layman, director of investment services for BKD Wealth Advisors, LLC (BKDWA) and **"Market Commentary"** columnist for the **BKD Advisor** was busy preparing for his May 19 broadcast debut as guest host of Bloomberg's **Open Exchange**.

Hosted by Suzy Assaad, this hour-long program provides a forum for "some of the best minds on Wall Street and in corporate America" to share their insight and unique perspectives on economic matters and investment strategies.

"Traveling to New York to co-host a live segment of **Bloomberg Television** was an opportunity I wouldn't have thought possible a few years ago, given our firm's Midwestern roots," says Layman. "It demonstrates the presence BKD Wealth Advisors has established as a leading wealth-management firm."

With Bloomberg media's strong presence, Layman's **Open Exchange** appearance scored a well-earned coup for BKDWA and served as a gateway to a variety of other established nationally broadcast programs and publications.

WealthPlan News Digest

In addition to Layman, Wayne Starr and Gary Garwitz are among the BKDWA professionals whose tips and strategies for personal wealth and estate planning have garnered national media attention from a list that includes CNBC's **Power Lunch**, the **AARP Bulletin**, **BusinessWeek**, the **Chicago Sun-Times**, **The Kansas City Star**, **Smart Money** and **The Wall Street Journal**.

To follow BKDWA's continuing media coverage and to reap its benefits, visit **http://www.bkd.com/mediacenter/WealthPlan_NewsDigest/**. The next issue of **BKD Advisor** will include "WealthPlan News Digest," a new calendar to keep you posted on future BKDWA national broadcasts, published articles and webcasts. ❖❖❖

Demand drives current M&A . . .

continued from page 5

don't yet know how the demand side will react, but we expect a fundamental shift in supply in the mid to long term.

On May 28, 2003, President Bush signed the *Jobs and Growth Tax Relief Reconciliation Act of 2003* (JGTRRA), which included a temporary reduction in the capital gains tax and a reduction in tax on qualified dividends to the new 15% capital gains rate.

This relief will expire in 2010. With the Democrats taking control of Congress in last year's mid-term elections, and with a presidential election in 2008, there is great debate about whether this temporary reduction will be extended, eliminated or allowed to expire.

In any case, the opportunity for change exists, and we believe it will have an impact on the supply function as sellers attempt to get in front of this issue. We are advising our clients to contact their BKD tax advisor about the potential tax impact on their unique situation.

To be sure, the current market fundamentals are generally favorable for robust acquisition activity in 2007. Credit is relatively cheap and readily available, the equity markets are strong, technology is easing the impact of deal integration, and globalization creates the need for consolidation.

If you are a seller or plan to exit in five years, now is the time to evaluate your

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