



Economic Stimulus Act of 2008

The *Economic Stimulus Act of 2008* (the Act) has been signed into law, with individual and business tax provisions designed to boost the lagging American economy.

The following summarizes three key provisions of the Act—one that will affect individuals and two that are geared to businesses.

Individual tax rebates – The Act provides qualified individuals rebates equal to the greater of:

1. \$600 for a single taxpayer and \$1,200 for married couples (limited to 2007 income tax liability)
2. \$300 for an individual and \$600 for a married couple

To qualify for the rebate, you must have \$1 of tax liability or \$3,000 of quali-

fyng income for 2007. Qualifying income is the sum of net self-employment income, veterans' disability payments (includes payments to survivors of veterans) and Social Security benefits. If you receive \$1 of the income tax rebate and have children, you will also receive \$300 per child.

The amount of the rebate is phased out at a rate of 5% for adjusted gross income in excess of \$75,000 (\$150,000 in the case of joint returns).

Section 179 limits – In lieu of depreciation, small business taxpayers may elect to expense the cost of qualified assets that otherwise must be depreciated over a number of years. Effective for taxable years beginning in 2008, the Act increases the expensing limit from \$128,000 to \$250,000 and the phase-out threshold from \$510,000 to \$800,000.

Bonus depreciation – The Act allows a trade or business to depreciate an additional 50% of the cost of most new personal property and leasehold improvements acquired and placed in service in 2008. However, only new property qualifies; used property does not. In addition, the limitation on the amount of depreciation deductions allowed for passenger automobiles in the first year increases by \$8,000.

These provisions are effective for property placed in service after December 31, 2007, and before January 1, 2009.

Operational excellence: setting the target for performance

by Bruce E. Jacobs, bejacobs@bkd.com

Editor's note: "Creating Competitive Distinction: a Journey with Discipline" appeared in the September 2007 BKD Advisor. The article covered how businesses can create competitive distinction by meeting what author Bruce E. Jacobs terms the four Must Get Rights—product leadership, operational excellence, customer delight and new business growth.

The following is about setting the target for performance. According to Jacobs, this is what drives the continual work effort to achieve operational excellence—and maintain it. * * *

Operational excellence results when an enterprise's management is involved with every aspect of business operations:

- ◆ Improving and simplifying processes
- ◆ Improving direct, indirect and support costs incurred by the enterprise
- ◆ Improving productivity of assets and labor
- ◆ Eliminating anything defined as waste

The ultimate benefit is the continual improvement in cost structure and asset utilization, *i.e.*, doing more for less. Every enterprise that provides a product or service is pressured by its customers to lower prices. Customers will keep exerting greater pressure, just as they will continue to search alternate sources for lower-priced products.

As enterprises incur increased costs for raw materials, skilled labor, manufacturing, distribution, energy, regulatory compliance, interest and other direct and indirect costs, the inability to raise prices to offset cost increases erodes the profit margins for all players in the industry.

Enterprises that compete in their markets on the single dimension of price require a business model with two core competencies: high-volume products and least total landed cost. Enterprises recognized for competitive distinction within their industry and by their competitors are able to compete on multiple dimensions

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New tax requirements for disregarded entities

Single-member limited liability companies (LLCs), qualified subchapter S subsidiaries (QSubs) and certain other entities are recognized for state law purposes but are disregarded for federal tax purposes. These “disregarded entities” have become quite popular over the past 10 years, because proper structuring can result in legal protection with simplified tax reporting.

Example: XYZ, Inc. is the sole owner of ABC, LLC, and no special entity election has been made for ABC, LLC. For legal purposes, ABC, LLC is treated as separate from XYZ, Inc., shielding XYZ, Inc. from potential claims against ABC, LLC. However, because ABC, LLC has only a single member, it is disregarded for fed-

eral tax purposes and the two entities are treated as one, allowing for simplified tax reporting.

Effective January 1, 2008, disregarded entities will not be ignored for federal excise tax purposes; effective January 1, 2009, they will not be ignored for federal employment tax purposes.

Accordingly, disregarded entities will have to file separate excise tax returns starting in 2008. This includes excise taxes reported on Forms 720, 730, 2290, and 11-C, as well as for excise tax refunds or payments claimed on Form 8849 and excise tax registration on Form 637.

Starting in 2009, disregarded entities will have to file separate employment tax returns unless a common paymaster is used. A related group of business entities generally may establish a common paymaster to pay employees of all entities in the group, which helps simplify payment, reporting and record keeping.

If your business group uses disregarded entities, consider establishing a common paymaster by January 1, 2009, to avoid reporting and record-keeping complexity.

IRS challenges purported welfare benefit plans

The Internal Revenue Service (IRS) has issued guidance it will challenge certain arrangements known as single-employer welfare benefit plans [Internal Revenue Code (IRC) Section 419(e) plans], sold primarily to professional corporations, e.g., physician groups and other small businesses.

The targeted arrangements involve the use of a purported welfare benefit plan to hold life insurance policies with cash surrender value or the equivalent.

While IRC Sections 419 and 419A allow employers to set up legitimate arrangements for post-retirement medical and life insurance benefits for employees. The IRS thinks such plans with cash-surrender value life insurance are typically not legitimate.

Promoters sell the plans as a way to provide business owners cash and other property on a tax-favored basis. Employer's contributions are often based

on unreasonable actuarial assumptions. Promoters claim these contributions are deductible, with little or no corresponding inclusion in the owner's income.

The IRS has generally identified these plans as “listed transactions,” i.e., abusive tax shelters, that require the filing of a special disclosure form. Failure to make this disclosure results in onerous penalties.

For more information about listed and reportable transactions, visit bkd.com/service/Tax/ReportableTransactions/index.htm. If your business has a purported welfare benefit plan involving cash surrender value life insurance, contact your BKD advisor as soon as possible.

Standard mileage rate for businesses increases

The optional business mileage allowance for automobiles increased to 50.5 cents in 2008,

two cents more than the 2007 allowance for business



travel. However, the rate for using a car to get medical care or in connection with a move that qualifies for the moving expense deduction is now 19 cents per mile, down a penny from the 2007 allowance. The mileage rate for driving an auto for charitable use during 2008 remains unchanged at 14 cents per mile.

Instead of claiming separate deductions for lease payments or depreciation, maintenance, repairs, tires, gas, oil, insurance and license and registration fees, you may use the mileage allowance method.

This method may also be used for leased autos. However, it must be applied over the entire term of the lease; thus, lessors cannot switch to deduct actual expenses in a later year.

Separate deductions for parking fees and tolls connected to business driving may be claimed in addition to the mileage rate. The mileage allowance method cannot be used for the following:

- ◆ Vehicles for hire, e.g., taxicab services, fleet operations or certain rural mail carriers

Don't bite: new scam seeks to exploit Economic Stimulus Act

A news item in the December BKD Advisor alerted readers to “phishing” scams, where cyber crooks pose as IRS representatives and try to persuade victims to divulge personal information about their identities and financial accounts.

Potential victims report new phishing scams are based on the *Economic Stimulus Act* (see lead item, page 1). Scammers posing as IRS representatives are requesting confidential information, saying it's needed to process the rebate checks many taxpayers are expected to receive.

Never give personal or financial account information to anyone, no matter how convincing or authoritative they may be, no matter how authentic their message.

The IRS, financial institutions and other legitimate organizations never ask for such information because they either already have it or do not need it. ♦♦♦

- ◆ Vehicles previously depreciated using accelerated depreciation methods, including the Code Sec. 179 expensing deduction
- ◆ Five or more owned or leased autos used simultaneously

If you use the standard mileage rates, you can switch in a later year to deducting the business-connected portion of actual expenses, subject to certain depreciation limitations.

For 2008, the depreciation component of the mileage rate is 21 cents per mile, up from 19 cents for 2007. The depreciation component reduces the basis of the auto for gain or loss purposes.

The main advantage of the standard mileage rate is reduced record keeping. Mileage-rate users need not keep a record of actual expenses or retain receipts; a record of the time, place, business purpose and number of miles traveled is sufficient. This method may result in a smaller deduction than claiming actual vehicle business expenses; however, it may result in a larger deduction for thrifty, high-mileage models.

Employees whose employers require them to supply their own autos may be reimbursed at a rate not exceeding 50.5 cents per mile for employment-connected business mileage during 2008. The reimbursement is treated as a tax-free accountable-plan reimbursement if the employee substantiates the time, place, business purpose and mileage of each trip.

FASB clarifies nonpublic FIN 48 deferral

The Financial Accounting Standards Board (FASB) issued guidance to clarify its deferral of the effective date of FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes* for nonpublic enterprises, including nonpublic not-for-profit organizations. (See the December 2007 BKD Advisor for more information about FIN 48.)

FIN 48 essentially provides that enterprises issuing financial statements using generally accepted accounting principles (GAAP) cannot recognize tax benefits of a tax position unless it is more likely than not to be sustained.

The guidance provides:

1. FIN 48 will be deferred to annual periods beginning after December 15, 2007, for eligible enterprises
2. A nonpublic enterprise will be eligible for deferral unless it has issued a full set of *annual* financial statements adopting FIN 48
3. Privately held subsidiaries of public companies are not eligible for deferral

The result is nonpublic enterprises, including financial institutions and exempt organizations, will generally not be required to adopt FIN 48 for GAAP financial statements until years beginning after December 15, 2007.

Limited tax exclusion for discharged mortgage debt

The *Mortgage Forgiveness Debt Relief Act of 2007* (the Act) was recently signed into law, providing a limited tax exclusion for discharged home mortgage debt.

Discharge of indebtedness generally results in taxable income to the debtor; exceptions include bankrupt or insolvent debtors, certain student loans, certain farm indebtedness and certain real property business indebtedness.



The Act generally allows taxpayers to exclude up to \$2 million of mortgage debt forgiveness on their principal residence; however, the taxpayer's basis in his or her principal residence is reduced by the excluded amount, but not below zero. This provision is effective for indebtedness discharged on or after January 1, 2007, and before January 1, 2010.

The mortgage forgiveness exclusion only applies with respect to a taxpayer's principal residence; therefore, although interest on a vacation home may be deductible, debt forgiveness on a vacation home is not excludible. In addition to provisions related to mortgage forgiveness relief, the Act includes several other measures to effect the following:

- ◆ Liberalize exclusion rules for home sales by surviving spouses; qualifying surviving spouses can exclude up to \$500,000 of gain from the sale of their primary residence within two years of a spouse's death (without this additional exclusion, only \$250,000 of gain would be excludible)
- ◆ Extend the deduction for mortgage insurance premiums for qualifying taxpayers with adjusted gross income of less than \$110,000 (\$55,000 if married filing separately)
- ◆ Provide volunteer firefighters and emergency responders a new taxable income exclusion of up to \$360 per year of state or local tax rebates or payments tax free
- ◆ Modify the qualification tests for cooperative housing corporations to help those that receive rental income
- ◆ Make single parents who are also full-time students eligible tenants for the low-income housing credit
- ◆ Increase penalties for failing to file a partnership return in a timely manner
- ◆ Penalize failure to file an S corporation return in a timely manner

RS issues guidance on S corp health insurance

If a shareholder-employee owns 2% or more of an S corporation, when is he/she entitled to an above-the-line deduction for health insurance premiums? Recent IRS guidance says accident and health insurance premiums are treated as taxable compensation if they are paid for or furnished by an S corporation in consideration for services provided by such an employee.

The S corporation may deduct these costs and include them in the W-2 wages of the shareholder-employee; however, the costs are not subject to *Federal Insurance Contributions Act* (FICA) taxes.

Shareholder-employees gener-



ally may deduct these costs above the line on their individual tax return, but this deduction is not available if they are eligible to participate in any other subsidized health plan, including one maintained by a spouse's employer.

New guidance states a plan providing medical coverage for a 2% shareholder-employee is established by the S corporation if it makes the premium payments. If the shareholder-employee pays the premiums, he/she must furnish proof of payment and be reimbursed by the S corporation in the current taxable year.

If the premiums are not paid or reimbursed by the S corporation, they are not deductible above the line. Further, the amount paid or reimbursed by the S corporation must be reported as taxable income on the shareholder's W-2. If it isn't, the premiums aren't deductible above the line.

The shareholder must report the premium payments or reimbursements as gross income on his/her Form 1040 but can offset this income with the above-the-line deduction.

One-year AMT patch signed into law

The *Tax Increase Prevention Act of 2007* (TIPA) provides a one-year alternative minimum tax (AMT) patch for 2007. Without it, millions more individuals would have been subject to AMT on their 2007 tax returns.

The AMT is the excess of the tentative minimum tax (TMT) over the regular tax for the year. To arrive at the TMT, an individual begins with taxable income, modifies it with various adjustments and preferences, *e.g.*, add-backs for property and income tax deductions and dependency exemptions, and subtracts an exemption amount that phases out at higher income levels.

The result is alternative minimum taxable income (AMTI), subject to an AMT tax rate of 26% or 28%. Under pre-TIPA law, the following are an individual's AMT exemption amounts for 2007 before income phase-out:

- ◆ \$45,000 for married individuals filing jointly and surviving spouses
- ◆ \$33,750 for unmarried individuals

- ◆ \$22,500 for married individuals filing separately

TIPA increases these exemption amounts for 2007:

- ◆ \$66,250 for married individuals filing jointly and surviving spouses (\$3,700 higher than 2006)
- ◆ \$44,350 for unmarried individuals (\$1,850 higher than 2006)
- ◆ \$33,125 for married individuals filing separately (\$1,850 higher than 2006)

TIPA also provides the following credits can be used to offset AMT:

- ◆ Dependent care credit
- ◆ Credit for the elderly and those who are permanently and totally disabled
- ◆ Mortgage credit
- ◆ Child tax credit
- ◆ Hope and Lifetime Learning credits
- ◆ Adoption credit
- ◆ Lower-income saver's credit
- ◆ Nonbusiness energy property credit for energy-efficient improvements to a principal residence
- ◆ Residential energy-efficient property credit for solar electric, solar hot water and fuel-cell property added to a residence
- ◆ Washington, D.C.'s first-time home-buyer tax credit

TIPA only offers a temporary fix. Absent Congressional action this year, millions of additional individual taxpayers will be subject to the AMT in 2008.

Employee or independent contractor?

For federal income and employment tax purposes, an area of recent IRS interest is whether a worker is an independent contractor or employee. The determination is intensely factual and the stakes can be high.

If a worker is an employee, the company must withhold federal income and payroll taxes, pay its share of FICA taxes on the employee's wages (plus FUTA tax) and must often provide the fringe benefits

it makes available to other employees. There may also be state tax obligations.

The above doesn't apply for workers who are independent contractors. A business is only obligated to send contractors a Form 1099-MISC for the year that shows what they were paid and only then if they were paid \$600 or more.

What constitutes an "employee"? There is no uniform definition of the term. Under common-law rules, an individual generally is an employee if the enterprise he/she works for has the right to control and direct him/her in terms of job responsibilities and how to perform them. Otherwise, the worker is considered an independent contractor.

Some employers that have misclassified workers as independent contractors are relieved from employment tax liabilities under Section 530 of the *Revenue Act of 1978*. Section 530 protection applies only if the employer (1) files all federal returns consistent with its treatment of a worker as an independent contractor, (2) treats all similarly situated workers as independent contractors and (3) has a reasonable basis for not treating the worker as an employee.

Example: A reasonable basis exists if a significant segment of the employer's industry has traditionally treated similar workers as independent contractors; however, Section 530 does not apply to certain types of technical-services workers.

Individuals who are "statutory employees," *i.e.*, specifically identified by the tax code as employees, are treated as employees for Social Security tax purposes, even if they aren't subject to an employer's direction and control. Statutory employees include agent-drivers and commission drivers, life insurance salespeople, home workers and full-time traveling or city salespeople who meet a number of tests.

Individuals who are "statutory independent contractors," *i.e.*, specifically identified by the tax code as nonemployees, are not employees for purposes of wage withholding, FICA or FUTA and the income tax rules in general. These include qualified real estate agents and certain direct sellers.

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Operational excellence sets target . . .

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because product price is not the only value component perceived by the customer.

Asset-based enterprises should measure operational excellence by their return on assets (ROA). By comparison, the minimum threshold of acceptable ROA you generate is the return on investment (ROI) that can be obtained in the open financial market with minimal risks.

The challenge is to determine your ROA target. Moreover, as your company absorbs cost increases and is unable to raise prices to offset them, achieving year-over-year (YOY) improvement in ROA requires rigorous effort by management.

The objective is to increase your long-term value and manage your company to achieve a sustainable higher value. As a performance measurement, ROA is the percent of operating profit (calculated on a before-tax basis) to total net assets. Improve the ROI by establishing an ROA target and YOY improvements, then focus on several key areas:

- ◆ Asset utilization and productivity to increase output using fewer assets
- ◆ Cost improvement to raise operating profit and offset cost increases
- ◆ Revenue growth to increase volume, market share and penetration

Defining your ROA target

Defining your ROA target can be as simple as having stockholders and management decide what the company should reasonably attain. Other methods compare industry competitors or compare your company to others with similar markets, products, customers, processes and industry issues. To establish a realistic ROA target:

- ◆ Identify your ROA over the last five years and determine the average five-year return
- ◆ Compare your ROA with that of your peers; keep data maintenance to a minimum by limiting the peer group to 20 companies
- ◆ Determine the performance gap between your company and those in the peer group

- ◆ If a peer-group company performs better, determine the economic benefits for your company if it performs at the same level

Based on the expected operating profit margin (OPM), if an enterprise only focuses on improving revenue, then revenue generally has to increase an inordinate amount in a single year to achieve the targeted return.

If the enterprise focuses on asset utilization and productivity, including cash, accounts receivables, inventory and net plant property and equipment, the operating profit doesn't have to improve to achieve the targeted return because the asset base becomes more productive—*more for less*.

Based on your projected operating profit and total net asset base, determine the targeted ROA by calculating the operating profit required to generate it. The gap between the projected and required operating profit is achieved through cost reductions or price increases, which may not be possible.

Achieving YOY improvements in ROA performance has a compounding effect on growth; however, as annual ROA performance improves, more is required from performance gains in revenue, asset utilization and operating profit.

Using ROA to improve your company's value requires revenue improvements, asset utilization and cost improvements in various combinations that depend on the current business and economic climate. Smart executives and operating managers take appropriate actions they know are right for the company in the longer term.

In view of the historical ROA performance of both your company and the peer group, determine the ROA the company should achieve. This is the targeted performance. Ideally, executives review the company's performance for the previous year and establish the ROA target it should be able to hit.

Achieving your target

Once you establish the target ROA, determine the improvements you will make.

Based on last year's financial performance, *e.g.*, total costs, operating profit before tax, total revenue and the net total asset base of the company, assess the following:

- ◆ Is the asset base with the new year's additional capital investments adequate to support the projected revenue for the new year?
- ◆ Based on the prior year's total expenses and operating profit margin, will the projected sales revenue generate sufficient profit to meet the targeted return on assets?
- ◆ If the required return on assets will not be achieved, what tactics will help increase revenue, reduce assets and improve profitability?

Now the work begins for executives and operations managers. It's their job to improve performance and achieve the targeted ROA. To achieve the target, does management work on asset utilization, costs and profitability, revenue growth or a combination thereof? It depends on your situation, but most companies strive to balance multiple factors.

Your company can achieve operational excellence and maintain it with proper attention to the following:

- ◆ Establish ROA as the primary measurement of financial performance
- ◆ Establish consistent operating profitability
- ◆ Improve skills of executives and management to efficiently manage assets

The measurement is easy to calculate and use and is easily understood by the operations managers who make decisions to improve ROA and the company's long-term value. Driving operational excellence based on ROA requires management to focus on continuous improvements that generate the targeted return.

Each year, the target performance is increased, which requires YOY performance gains and demonstrates consistency in the profitability and growth of your enterprise's long-term value. ❖❖❖



Market update & outlook: economy

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

Third-quarter economic growth was unexpectedly strong in 2007, with GDP advancing at a real rate of 4.9%. This represents the fastest pace of growth in four years, despite the negative impact of the housing slowdown and the sub-prime loan crisis.

The weakening dollar increased the attractiveness of U.S. goods to foreign buyers, creating significant strength in exports during the quarter. Inventory building was also a notable contributor to growth.

Yet growth in the fourth quarter clearly slowed, as consumers wrestled with the dual effects of declining home prices and escalating energy costs resulting from record-high oil prices of nearly \$100 per barrel. Though employment conditions remained solid throughout most of the year, signs emerged late in the quarter that layoffs in the construction and financial services industries were moving the unemployment rate upward.

Finally, the recent deterioration in credit quality led to tightened lending standards that hampered economic activity. Combined, these factors point toward a significant deceleration in fourth-quarter growth, most likely to the area of 1%.

The Federal Reserve Bank (Fed) continued to reduce interest rates during the quarter and lowered its benchmark Fed Funds rate .25% at both the October and December meetings. This brings the cumulative amount of Fed easing to 1.00% since late September. As we head into 2008, the Fed clearly is concerned about risks to economic growth and has taken aggressive action to mitigate them.

With credit concerns worsening almost daily, many economists now feel the U.S. economy faces a 50-50 chance of recession in 2008.

Although this possibility must be considered, the current environment lacks some of the typical predictors of recession, including sharply rising jobless claims, prolonged profit declines and a sustained drop in equity prices. In our view, the economy is likely to decelerate significantly in 2008 but avoid recession.

Stocks volatile in 2007

In the latter half of the year, the market vacillated several times between year-to-date returns of 0% and +10% and, perhaps fittingly, closed out 2007 in the middle of this range.



Financial firms sustained losses in risky mortgages and slowing housing activity, which created a drag against the positive effect of strong exports.

Here are the final results for 2007, for the major market averages:

Equity Index	4Q 2007	YTD 2007
S&P 500	-3.33%	5.49%
S&P Mid-Cap 400	-2.73%	7.98%
Russell 2000	-4.582%	-1.57%
MSCI EAFE	-1.75%	11.17%

Despite the modest overall gain for the S&P 500 index, all sectors—except for Financials and Consumer Discretionary—posted positive results for the year. Returns above 10% were actually produced in 2007 by six of the eight remaining sectors, including Energy, Materials, Utilities, Technology, Consumer Staples and Industrials.

Increasing commodity prices were a positive influence on Energy and Materials stocks, while high exposure to international markets benefited Technology, Consumer Staples and Industrials. The weakness in Financials and Consumer Discretionary

stocks masked significant strength in most other parts of the economy.

After several years of outperformance, small-cap stocks languished in 2007, posting negative results for the year. Small-cap companies typically have a much smaller international share of revenues, increasing their dependence on the slowing U.S. economy. Smaller companies also tend to outperform in the early stages of an economic expansion and underperform as the cycle matures.

International stocks posted another strong year of gains in 2007, with the MSCI EAFE index advancing more than 11% for the year. In local currency terms, the stocks that comprise the EAFE index gained just 1.17% in 2007, meaning the weakening dollar accounted for 10% of the 11% total return posted for the year.

Some currency experts believe the decline of the dollar against many major world currencies may have run its course. So, although we believe the environment of global growth will continue to be above average, the out-sized international returns experienced in recent years may be more difficult to come by going forward.

On a trailing 12-month basis, the S&P 500 index trades at about 18 times earnings. This is an increase from the P/E of 16, at which the market traded for most of 2007 due to declining financial sector earnings in the latter half of the year. Based on current estimates, S&P 500 trading at just 15 times 2008 earnings represents a very reasonable valuation level.

Credit concerns affect bond returns

A returns dichotomy developed in the bond market in the final months of the year, as the “flight to quality” and Fed rate cuts pushed Treasury bond prices up, resulting in strong total returns. Meanwhile, credit concerns had a significantly negative impact on the lower-



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quality portion of the bond market, as well as for certain investment-grade financial issues.

In addition, several bond insurers, including heavyweight MBIA, were either downgraded by the major ratings services or placed on “negative credit watch.” These negative credit actions are the result of increasing loss exposure from insuring debt linked to the subprime mortgage market.

For bond holders, the significance of these downgrades is the underlying bonds assume their insurers’ ratings, causing a general decline in credit ratings for the insured bond universe. This dynamic contributed to modest total municipal bond returns in 2007, with the Lehman Municipal index gaining slightly less than coupon rates, at 3.36%.

In the marketplace, the return of the leveraged buyout (LBO) transaction has also affected the credit quality of certain bond issuers. When an LBO buyer takes a company private, it uses large amounts of debt to purchase outstanding stock, resulting in a much larger debt burden for the private company going forward.

In light of a decelerating economy and the general deterioration in credit conditions, the bond market has viewed these transactions negatively, causing price declines in the related issues.

In some respects, the 2007 bond market offered investors more “land mines” than the stock market, despite the fact the asset class is generally the least risky of the two. However, for those who emphasized quality in the bond component of their portfolios, 2007 produced the best total returns since 2002, with the Lehman Aggregate index rising 6.97% for the year.

Outlook for 2008

The 2008 investment year will likely play out in two halves: In the first, subprime mortgage pain and further slowing in

housing will continue to be a dark cloud over the markets. These issues will propagate in the form of poor earnings results for financial and consumer discretionary stocks in the first half of the year, more near-term headline risk and weakening employment reports as the construction and financial services industries downsize.

Election-year uncertainty will also keep a lid on stock market performance in the first half of 2007. With no clear front-runner in the presidential race, and some expectation of a change in party control, the market will have difficulty advancing until this uncertainty resolves as November draws closer.

The second half of the year ought to see an improvement in market sentiment as the cumulative impact of successive Fed easings starts to positively influence the economy and improve prospects for growth. The Fed has taken a proactive stance in its efforts to protect the economy from entering recession, and all indications are it will continue to aggressively lower interest rates in 2008 until financial conditions improve.

The Fed’s actions have a lagged impact, which is why we won’t see the benefits to the economy until the second half of the year. In addition, the presidential race will be decided in the fall, removing another source of uncertainty for stocks, irrespective of who moves into the White House.

As mentioned earlier, we believe the risk of recession is rising; however, the strong global economy, the weak dollar and a proactive Fed should help us avoid consecutive quarters of contraction.

Ironically, the rising risk of recession

has also increased the chances of significant rate reductions in the future, which should moderate the economy’s deceleration and increase the power of the eventual rebound.

Look beyond the current headlines for a more promising investment picture: Stocks, both here and abroad, are attractively valued at roughly 15 times 2008 earnings expectations. This relatively low level of valuation implies many of the concerns of today are reflected in share prices.

Stock market performance has been consistently positive 12 months past an initial Fed easing (the one exception in recent years was post-9/11) due to the improvement in growth prospects.

Our financial system is generally well-capitalized, so, although there will be losses from subprime loans at most lending institutions, these problems will eventually work their way out of the system.

Finally, periods of unbridled optimism generally *feel* better to investors, but times of uncertainty like these often create better investment opportunities going forward. ♦♦♦



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Some categories of individuals are subject to special rules based on their occupations or identities, *e.g.*, corporate directors aren't employees of a corporation in their capacity as directors, and partners of an enterprise organized as a partnership are treated as self-employed persons.

Under certain circumstances, you can ask the IRS to rule on whether a worker is an independent contractor or employee by filing Form SS-8. The IRS has also developed a new form for employees who believe an employer has misclassified them as independent contractors. Form 8919, *Uncollected Social Security and Medicare Tax on Wages*, is now used to figure and report the employee's share of uncollected Social Security and Medicare taxes due on his/her compensation.

Ruling affects investment advisory fees

In a landmark case, the U.S. Supreme

Court has ruled investment advisory fees paid by a trust are deductible only to the extent they exceed 2% of the trust's adjusted gross income (AGI).

Miscellaneous itemized deductions are allowed only to the extent they exceed 2% of AGI. For purposes of this floor—subject to certain exceptions—the AGI of a trust is computed the same way it is for an individual.

Under one exception, costs aren't subject to the 2% limitation if paid or incurred in connection with administration of a trust and wouldn't have been incurred if the property was not held in trust.

Whether a trust's fees for investment advice meet this exception has been an issue of contention between taxpayers and the IRS for more than 15 years. Various courts have ruled differently on this issue, but the U.S. Supreme Court has finally weighed in and ruled in favor of the IRS.

In determining whether a particular type of cost incurred by a trust wouldn't have been incurred if an individual held the property, the court ruled only costs uncommon for an individual to incur are eligible. Trustees will have to follow this decision in preparing trust tax returns.

Growing your business takes preparation

Growing your business is exciting but stressful, with many issues to consider—marketing, human resources, tax, legal, etc. Consider the following as you grow your business to the next level:

- ◆ Examine your values and goals, form a mission statement and stick to it.

- ◆ Consult outsiders and build a team of experts to help navigate unknown waters and network with experienced people who have already been there.
- ◆ Invest in talented people before you need them. If growth is rapid, add a chief operating officer or chief financial officer—part-time or as a consultant.
- ◆ Learn to prioritize and delegate; free yourself to lead, plan and strategize.
- ◆ Follow the 80/20 rule for customers, *i.e.*, 20% of a business's customers generate 80% of its profit. Don't just focus on gross revenues; pay attention to the bottom line, even if it means weeding out some of your customers.
- ◆ Weather the unexpected; have reserve capital, which can be available credit in addition to cash. ❖❖❖

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