



Summary of tax provisions in the *Food, Conservation and Energy Act of 2008*

The *Food, Conservation and Energy Act of 2008* became law on May 22, 2008, by Congressional override of Presidential veto. Title XV of this law, the *Heartland, Habitat and Horticulture Act of 2008* (Farm Act) provides tax changes of significance, including specialized tax breaks for the farming industry, limitation on farm losses, changes in credits for the production of certain fuels (namely ethanol) and tax breaks for Kansas storm victims. Following is a summary of notable tax provisions in the Farm Act.

Conservation reserve payments to retired & disabled farmers

Self-Employment Contributions Act (SECA) tax, or self-employment tax, is imposed on an individual's net earnings from self-employment. Self-employment includes any trade or business completed on by the individual. Rentals from real estate and from personal property leased with the real estate, including rentals paid in crop shares, are generally excluded in determining net earnings from self-employment.

The Conservation Reserve Program (CRP) is a voluntary program designed to conserve and improve soil, water and wildlife resources. The program pays "annual rentals" to landowners and operators who agree to enroll their land in the program.

The IRS initially treated CRP payments as not subject to SECA; however, in recent years it has proposed to treat almost all CRP payments as self-employment income.

The Farm Act provides that CRP payments made after 2007 are not self-employment income for SECA tax purposes if received by an individual who is getting

Social Security retirement or disability payments.

Limitation on farm losses

Taxpayers who materially participate in a farming activity may deduct net farming losses. Taxpayers who do not materially participate in a farming activity may only deduct net farming losses against income from other passive activities.

For tax years beginning after 2009, the Farm Act limits the farming loss of a taxpayer, other than a C corporation, for any tax year in which that taxpayer receives any applicable subsidies. The losses are limited to the greater of \$300,000 (\$150,000 for a married person filing separately), or the taxpayer's total net farm income for the prior five tax years.

Applicable subsidies are any direct or counter cyclical payments under Title I of the *Food, Conservation and Energy Act of 2008* (or any payment elected in lieu of any such payment) or any Commodity Credit Corporation (CCC) loan.

Losses disallowed under the new rule are carried forward to the next tax year. Farming losses arising because of fire, storm or other casualty, or by reason of disease or drought, are disregarded for purposes of calculating the limitation.

For partnerships and S corporations, the limit is applied at the partner or shareholder level.

Contributions of real property for conservation

To encourage charitable contributions of real property for conservation

purposes, special rules apply to donations made in 2006 and 2007. In general, various limitations that normally apply to donations of real estate are eased for these donations, especially if the contributor is a farmer. These incentives were scheduled to expire after 2007, but the Farm Act extends them through tax years beginning before 2009.

Endangered species recovery expenses

A taxpayer in a farming business may elect to deduct expenditures for soil or water conservation in the year paid or incurred, up to 25 percent of gross income from farming. Any excess is carried forward to the next year.

The Act provides similar treatment for expenditures farmers pay or incur after 2008 to achieve site-specific management actions under the *Endangered Species Act of 1973*.

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Corporation's qualified timber gain

Gain from the sale or cutting of standing timber owned for more than one year is generally eligible for lower capital gains tax rates. However, lower capital gains rates do not apply to C corporations.

The Farm Act provides a 15 percent tax rate for C corporations on the portion of taxable income that consists of qualified timber gain. Qualified timber gain is the net gain from the sale or cutting of standing timber held more than 15 years.



This lower rate is temporary—it applies only to tax years ending after May 22, 2008, and beginning on or before May 22, 2009. So, for calendar year taxpayers, this lower rate only applies to the 2008 taxable year.

Alternative fuel provisions

The Farm Act contains the following provisions for alternative fuels:

- ◆ Reduction of the 51 cents-per-gallon tax credit for ethanol production to 45 cents per gallon for 2009 and 2010
- ◆ Tighter restrictions on the amount of denaturant, *e.g.*, gasoline, that can be mixed with alternative fuel qualifying for tax credits
- ◆ Extension of the tariff on ethanol imports through 2010
- ◆ A new \$1.01 per-gallon tax credit for cellulosic biofuel (ethanol and any other alcohol, ether, ester or hydrocarbon derived from dedicated energy crops and trees, wood and residues, plants grasses, agricultural residues, fibers, animal wastes, municipal solid waste and certain other materials) produced after December 31, 2008

Agricultural chemicals security tax credit

To encourage agricultural businesses to keep chemicals locked up and safe from theft, the Farm Act adds a new 30 percent credit for qualified chemical security expenditures by eligible agricultural businesses. The credit applies to expenses paid or incurred after May 22, 2008, and before December 31, 2012. The credit is limited to \$100,000 per facility, reduced by the aggregate amount of the credits allowed for the facility in the prior five years.

The total credit for a taxpayer is capped at \$2 million per year and deductible expenses must be reduced by the amount of the credit.

Racehorse depreciation

Under current law, racehorses over the age of two years are depreciated (expensed) over three years for tax purposes and racehorses under age two are depreciated over seven years.



The Farm Act provides that all racehorses placed in service after 2008 and before 2014 are depreciated over three years, regardless of age.

Kansas tornado disaster relief

The Gulf Opportunity Zone Act of 2005 (GO Zone Act), enacted late in 2005, provided tax relief measures for victims of Hurricanes Katrina, Rita and Wilma, plus special incentives to encourage rebuilding in the hurricane disaster areas.

The Farm Act extends many GO Zone Act tax breaks to the Kiowa, Kansas, Presidential Disaster Area hit by tornadoes in May 2007. Tax relief includes these measures:

- ◆ 50 percent first-year bonus depreciation
- ◆ Enhanced Section 179 expensing election for qualifying personal business property purchases
- ◆ Partial expensing of demolition and cleanup costs
- ◆ Five-year net operating loss (NOL) carryback
- ◆ Exemption from the 10 percent penalty tax for up to \$100,000 of qualified retirement plan distributions
- ◆ Eased casualty loss rules
- ◆ Employee retention credit
- ◆ Bond provisions designed to stimulate rebuilding in the affected area

Other tax provisions of note

The Farm Act also contains the following provisions:

- ◆ Liberalized rules for real estate investment trusts (REITs) holding timber interests
- ◆ New tax credit for holders of qualified forestry conservation bonds
- ◆ Like-kind exchange treatment under Code Section 1031 for shares in a mutual ditch, reservoir or irrigation company
- ◆ Changes to the optional method of computing net earnings from self-employment to allow more farmers with low net farm income to secure Social Security benefits
- ◆ The CCC must issue Form CCC-1099-G to report market gain associated with the repayment of a CCC loan, whether the taxpayer repays the loan with cash or CCC certificates
- ◆ Increases 2012 required estimated tax payments for corporations with assets of at least \$1 billion ❖❖❖

Summary of the *Heroes Earnings Assistance and Relief Tax Act of 2008*

The *Heroes Earnings Assistance and Relief Tax Act of 2008* (the 2008 Heroes Act) was signed into law June 17, 2008. The 2008 Heroes Act provides targeted tax relief for members of the military and their families, tightened expatriation rules and a new rule requiring U.S. companies working under federal government contract to withhold employment taxes on overseas employees' wages.

Certain of the relief provisions will require qualified retirement plan amendments.

Following are highlights of the tax provisions in the 2008 Heroes Act.

Relief provisions for military

The 2008 Heroes Act provides the following tax relief for members of the military and their families:

- ◆ Clarifies that those in the active military who file a joint tax return are eligible for the rebate payment under the *Economic Stimulus Act of 2008*, even if one spouse does not have a Social Security number.
- ◆ Makes permanent the ability to include combat pay as earned income for purposes of the earned income tax credit (EITC) (under pre-2008 Heroes Act law, this benefit was to expire after 2007).
- ◆ Makes permanent an exception that permits qualified mortgage bonds to be issued to finance mortgages for qualified veterans who served in the active military without regard to the first-time home buyer requirement (under pre-2008 Heroes Act law, this benefit was to expire after 2007).



- ◆ Modifies the law which provides certain retirement plan protections for reservists who are called to active duty and who are able to return to their civilian employers after serving the country. The new law requires tax-qualified retirement plans to provide that if a participant dies while performing qualified military service, his or her survivors would be entitled to any additional benefits (other than benefit accruals relating to the period of qualified military service) that would have been provided had the participant resumed employment and then terminated employment on account of death. Similar rules apply to 403(b) annuities and 457(b) plans. Additionally, the new law says retirement plans can permit individuals who leave for qualified military service and cannot be re-employed on account of death or disability to be treated as if they had been rehired as of the day before death or disability and then had terminated employment on the date of death or disability. These changes apply to deaths or disabilities occurring after 2006.
- ◆ Includes in the calculation of wages for retirement plan and IRA purposes the differential wages paid by an employer to an employee who becomes active duty military, effective for years beginning after 2008. Differential pay is also made subject to federal income tax withholding, effective for amounts paid after 2008.
- ◆ Extends the limitations period for filing tax refund credit claims arising from the Department of Veterans Affairs disability determinations.
- ◆ Makes permanent the expiring Internal Revenue Code provision that permits active duty reservists to make penalty-free withdrawals from retirement plans.
- ◆ Permits a military death gratuity or amount received under the Servicemembers' Group Life Insurance (SGLI) program to be rolled over to a Roth IRA or Coverdell education savings account, notwithstanding the contribution limits that otherwise apply.
- ◆ Offers Peace Corps volunteers and certain employees similar benefits of the home sale exclusion ownership and use period that members of the uniformed services, Foreign Service and intelligence community now receive. The act also makes the special home sale exclusion rules for certain employees of the intelligence community permanent and repeals the requirement that those employees move overseas to qualify for special treatment.
- ◆ Provides small employers with a 20 percent tax credit for differential wage payments made to employees who are on active military duty.
- ◆ Provides an exclusion for state or local payments of bonuses to active or former military personnel or their dependents because of their service in a combat zone.
- ◆ Allows members of the reserves who are called to active duty to withdraw unused amounts held in a health flexible spending account (health FSA).

Tightened expatriation rules

U.S. citizens and long-term U.S. residents are subject to tax on their worldwide income. Taxpayers can avoid U.S. taxes by renouncing their U.S. citizenship or terminating their residence. The Heroes Act tightens the expatriation rules to ensure that certain high net-worth taxpayers cannot renounce their U.S. citizenship or terminate their U.S. residency to avoid U.S. taxes. Under this provision, high net-worth individuals are treated as if they sold all of their property for its fair

market value on the day before they move out of the United States or terminate their residency. The taxpayer receives a gain to the extent that the aggregate gain recognized exceeds \$600,000 (which will be adjusted for inflation).

An individual may elect to defer payment of this tax, but interest will be charged at the rate for individual tax underpayments and a bond will be required.

Special rules apply to qualified deferred compensation attributable to services performed in the United States and paid by a U.S. person or company. The deferred compensation is not subject to the above tax. Instead, the payor, *i.e.*, the expatriate's employer, must withhold and remit income taxes at a 30 percent rate from payments of deferred compensation to an expatriate. Deferred compensation

that does not meet these requirements is treated as received by the expatriate the day before the expatriation date.

These provisions apply to those who relinquish U.S. citizenship or terminate their U.S. residency on or after June 17, 2008.

The Heroes Act also imposes a new tax on gifts and bequests from an expatriate or his estate to a U.S. citizen or resident, if the gift or bequest is not reported on a U.S. gift or estate tax return filed by the expatriate. Transfer taxes are normally imposed upon the transfer or the decedent's estate; however, in this instance the U.S. recipient of the gift or bequest will be taxed at the highest estate or gift tax rate (currently 45 percent), less the amount of gift or estate tax paid to a foreign country.

Employment tax withholding by controlled foreign entities working for U.S. government

The Heroes Act contains a provision that treats foreign subsidiaries of U.S. companies performing services under a U.S. government contract as American employers for employment tax purposes. Thus, U.S. FICA withholding will apply to wages for services performed outside of the United States by a U.S. citizen or resident in connection with a government contract. Under the new law, the domestic parent is jointly liable for employment taxes imposed on the foreign subsidiary. This provision applies to services performed in calendar months beginning more than 30 days after the enactment date. ♦♦♦

Tax rules on personal use of company vehicle

Many businesses provide company vehicles to employees for business use. Following are the tax basics in such a situation.

If the company owns the vehicle and an employee uses it for business and personal reasons, the personal use must be valued and treated as noncash compensation to the employee. Payroll taxes must be withheld and remitted on the value of personal use and reported on Form W-2.

An employer may deduct the costs of providing a vehicle to an employee—not the amount reported on the employee's Form W-2.

Deductions for the employer

The employer may deduct all of its operating expenses, *e.g.*, oil, gas, maintenance and repairs, and allowable depreciation or lease deductions. However, unless the vehicle is a heavy sport utility vehicle or truck, "luxury auto" limitations apply to depreciation and lease expenses.

The otherwise allowable depreciation and Section 179 expense deductions for a new business auto placed in service in 2008 are limited to \$2,960, \$4,800 for the second tax year, \$2,850 for the third and

\$1,775 for each succeeding year. For new light trucks, light SUVs or vans placed in service in 2008, the limits are \$3,160, \$5,100 for the second tax year, \$3,050 for the third and \$1,875 for each succeeding year. For new autos, light SUVs or vans bought and placed in service in 2008, the above otherwise applicable first-year depreciation dollar caps are boosted by \$8,000 under the *Economic Stimulus Act of 2008*.

These limits do not apply to a truck or SUV with a gross vehicle weight rating (GVWR) of more than 6,000 pounds. For these vehicles the employer may:

- ◆ Expense up to \$25,000 of the cost under Section 179
- ◆ Claim 50 percent bonus first-year depreciation, if bought new and placed in service in 2008
- ◆ Depreciate the remainder under the normal depreciation rules



If the vehicle is used by an individual who owns more than 5 percent of the company, the vehicle must be used at least 50 percent for business. Otherwise, Section 179 and bonus depreciation do not apply and slower depreciation rates apply.

If the vehicle is leased, and the lease is signed in 2008, lease expense deductions are indirectly limited if the value of the vehicle is \$18,500 or more (\$19,000 for light trucks, vans and SUVs). Leases signed in previous years are subject to the same limits, but the threshold values vary. Although the full lease payment may be deducted, a lease income inclusion applies to leased vehicles with values in excess of these amounts. The income inclusion is based on the initial fair market value of the leased auto, the lease term and the year of the lease and is adjusted for inflation each year. These factors are applied to IRS tables to calculate the inclusion amount.

Lease inclusion amounts are very small when compared to depreciation limitations. For example, a \$50,000 vehicle leased on January 1, 2008, for a three-year term is subject to an income inclusion amount of \$177 for 2008, \$388 for 2009 and \$575 for 2010.

In lieu of the above deductions

(actual expenses plus depreciation or lease expense), the standard mileage rate may be used to compute the employer's deduction. If personal use is properly valued and treated as compensation income, both business and personal mileage are deductible by the employer. However, the deduction resulting from the mileage rate method is likely smaller than the actual expenses plus depreciation or lease costs.

Valuing personal use

Generally, an employee's fringe benefit is worth its fair market value (FMV). For a vehicle, the FMV is the amount an individual would have to pay to lease the vehicle. However, if the employer leases the auto supplied to the employee, it cannot use its actual lease cost as FMV. The dealer that sold or leased the vehicle should be able to provide the vehicle's FMV leasing cost.

To arrive at the noncash compensation, the FMV, plus the value of gas, maintenance and insurance, is multiplied by the ratio of personal mileage to total mileage.

Instead of using the general FMV method, employers may use one of three optional methods:

- ◆ The annual lease value method (ALV)
- ◆ The cents-per-mile method
- ◆ The commuting value method

Of these alternative methods, ALV is most popular because of the many restrictions placed on the cents-per-mile and commuting value methods.

Under ALV, the employer must first determine the FMV of the auto on the first date on which the auto is made available for personal use. There are safe harbors for determining this value:

- ◆ For an auto owned by the employer, the employer's cost of buying it, including sales tax, title and other expenses
- ◆ For an auto leased by the employer, either: a) the manufacturer's suggested retail price less 8 percent, including sales tax, title and other purchase expenses, b) the retail value

of the auto as reported in a nationally recognized publication that regularly reports new or used auto retail values or c) the manufacturer's invoice price (including options) plus 4 percent

Once FMV is determined, IRS tables are used to compute the value of personal use. ALV is simplified because it takes into account the value of insurance and maintenance. However, it does not take into account the value of fuel provided to the employee.

If an employer provides fuel to an employee for personal use, its value must be added to the ALV amount. The value of fuel provided in-kind by an employer may be determined based on all the facts and circumstances, or at 5.5 cents per mile. With high gas prices, valuing fuel at 5.5 cents-per-mile results in a nice tax benefit for the employee.

If the employer reimburses an employee for the cost of fuel used for personal driving, or it provides a charge card, the value of the fuel is the amount of the actual reimbursement or the amount charged.

An employer is not required to use the same valuation method for all its vehicles. However, once a valuation method is chosen for a particular vehicle, it generally must be used for the life of the vehicle.

Regardless of the valuation method, business mileage must be substantiated. Employees should keep a diary or log with detailed entries for employment-connected business driving, *i.e.*, time, place, mileage, business purpose. The IRS routinely requests such documentation in examinations. Personal mileage equals total mileage less employment-connected business mileage. ♦♦♦

Business standard mileage rate increased

The IRS has announced the optional mileage allowance for business travel by automobile from July 1, 2008, to Dec. 31, 2008, will increase 8 cents—from 50.5 cents to 58.5 cents per mile. The increase is because of the increase in fuel prices. The mileage allowance for qualified medical transportation and for qualified moving expenses also will increase 8 cents for the last half of 2008 from 19 cents to 27 cents per mile, respectively.



The mileage allowance deduction replaces separate deductions for depreciation or lease payments, maintenance, repairs, tires, gas, oil, insurance and license and registration fees. Taxpayers may, however, claim separate deductions for parking fees and tolls incurred for business reasons.

Employers that don't furnish company cars to employees may reimburse them as much as the standard mileage rate without reporting the reimbursement as taxable compensation.

The mileage rate for driving an auto for charitable use remains unchanged at 14 cents-per-mile. This rate is set by law and cannot be changed by the IRS. ♦♦♦



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Market volatility continues

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Despite escalating concerns that the U.S. economy has entered recession, final first-quarter gross domestic product (GDP) growth was positive once again, albeit at a rather anemic 1 percent rate. While the revenue, profits and employment in both the financial and housing industries are contracting severely, most other parts of the economy continue to perform surprisingly well. Dollar weakness and the resultant surge in exports have benefited companies across a variety of industries. Excluding the financials and consumer discretionary sectors, profits for the other eight economic sectors are expected to grow by close to 10 percent in the second quarter.

One of the more troubling economic statistics is payrolls, which have now declined in each of the first six months of this year, a rare occurrence outside of a recessionary environment. However, the magnitude of these declines has not been that great—only one-half of 1 percent at an annual rate—which has kept the unemployment rate at about 5.5 percent, a reasonable level by historical standards. Employment conditions (job creation and real hourly wage growth) have proven to be more predictive of consumer spending trends over time than changes in home values or stock prices and are, therefore, important indicators of the health of the economy.

In May, households began to receive checks from the stimulus package passed by Congress earlier in the year. In the near term, these checks should help consumers endure the large increases in energy costs, and should also boost economic growth by about 1 percent. This should have provided enough of a boost to allow the economy

to post another slightly positive quarter of growth, once again narrowly avoiding the first official “recession” quarter of declining GDP.

Completing the most aggressive easing cycle in two decades, the Federal Reserve System offered just one additional rate cut during the quarter, dropping its Federal Funds rate by .25 percent to 2 percent in late April.

In a prepared statement from the last meeting in June, the Federal Open Market Committee (FOMC) said, “Although downside risks remain, they appear to have diminished somewhat, while the upside risks to inflation and inflation expectations have increased.” This statement caused many to believe that the Fed would start raising rates later in 2008 in order to contain inflation. Given the serious issues continuing to affect the U.S. consumer and the banking system, this scenario is not likely in our view.

Largest monthly stock decline in more than five years

After recovering most of the first quarter’s losses by the end of May, in June stocks posted their worst one-month decline since the bear market lows of September 2002. The declines in June were prompted by a Lehman Brothers announcement of significantly larger losses from subprime than estimated just a few weeks before. Just when many investors were beginning to believe banks and brokers had disclosed the worst of the losses, the possibility of another round of large write-offs loomed.

This news initiated a broad-based decline in global equities for the month, pushing the major indices back toward their lows of the year, as follows:

Equity Index	2Q 2008	YTD 2008
S&P 500	-2.73%	-11.91%
S&P Mid-Cap 400	5.43%	-3.90%
Russell 2000	.58%	-9.37%
MSCI EAFE	-2.25%	-10.96%

For the year, only the energy (+8.12 percent) and materials (+.19 percent) sectors posted gains, although modest rises relative to the rapid escalation in commodity prices. Six of the other eight S&P 500 economic sectors have posted double-digit declines this year, with financials (-30.89 percent) leading the way down. International stocks, the source of outsized returns in recent years, have fared poorly in 2008 as well, with both the developed and emerging markets indices declining more than 10 percent. As was the case at the end of the first quarter, the sell-off in stocks during June was very broad-based and especially steep in the bank and brokerage stocks.

The primary negative market influence this year continues to be the constant stream of loss reports from the financial industry related to subprime loans and derivative securities. Most of the major banks and brokerage stocks have declined 40-50 percent or more from their 52-week highs. Given the severity of these losses, more dividend cuts and additional capital raises are expected, both of which are detrimental to current shareholders. Entering 2008, the financial sector carried the largest weighting of the 10 economic sectors, so declines here have a large impact on overall market results.

Credit quality concerns persist in the bond market

Treasury yields remained relatively low as the “flight to quality” response in the bond market persisted in the second quarter. Although the yield on the 10-year Treasury note drifted upward in the sec-



in second quarter

ond quarter, it remained below 4 percent. Spreads available on mortgage bonds are historically wide, while corporate bond yields have normalized in most segments. Given that financial institutions are large issuers of corporate bonds, ratings downgrades have resulted in price declines for

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many issuers in this sector. Bond-specific risk also has developed in some of the bonds issued by the banks and brokers most exposed to subprime losses. The net result was a decline in the Lehman Aggregate Bond index of -1.02 percent for the quarter, bringing the year-to-date result to 1.13 percent.

After a tumultuous start to the year, prices stabilized in the investment-grade municipal bond realm during the second quarter. Although the major bond insurers continued to experience downgrades of their credit ratings, focus in the area of investment-grade municipal bond analysis returned to the underlying ratings of the issuing entities. Whereas bond insurance has been viewed in the past as extra protection that often resulted in an AAA rating, now the insurance provided by many of these companies is considered to be irrelevant to credit quality. Fortunately, the historical default rate for investment grade munis is extremely low. With the stabilization in bond prices, the Lehman Municipal Bond index was able to post a gain of .63 percent during the quarter, for a total year-to-date return of .02 percent.

Outlook for the second half of 2008

Subprime losses, escalating energy costs, election year uncertainty ... investors have much to be worried about today. Market sentiment is extremely bearish. Pessimistic environments such as this often produce the best opportunities for return going forward. We think this should ultimately be bullish for stocks.

From the bear market lows of October 2002 to the recent market peak in October 2007, the S&P 500 gained 96 percent, nearly doubling in value. Small-cap and international stocks produced even larger returns. Over this five-year period, the market posted gains in each calendar year from 2003 through 2007, and ordinary 10 percent market "corrections" were scarce. One could argue the stock market was due for a decline, as this has proven to be a recurring characteristic of this asset class. Unfortunately, the long-run returns that stocks produce (historically superior to those of most other asset classes) don't come in steady, even increments.

Arguably, to meet financial goals, it is more important for investors to stay the course in such turbulent times than it would be during more positive or stable environments. So far in 2008, mitigation of risk has been the name of the game, as return opportunities have been scarce.

From a valuation standpoint, global equities appear attractive relative to other investment alternatives. The 10-year Treasury note continues to offer a negative "real return" (after inflation and taxes), with a nominal rate of 3.98 percent at the end of the second quarter. Other portions of the bond market look somewhat better; inflation is still a concern, though, because of its ability to erode fixed returns. Stocks, on the other hand, have historically offered a natural hedge to inflation and trade at below-average valuations.

A continuation of headline risk related to the credit crisis seems likely. As news ebbs and flows, and investors prognosticate as to whether these troubles will spread into other parts of the economy, we can expect more volatility in stock prices. Election year uncertainty also will persist throughout the current quarter, making a significant reversal in share prices unlikely in the near term. However, today's news and uncertainty has already been discounted in stock prices.

Valuations are reasonable. The Fed has been very aggressive in easing and providing liquidity to the markets. BKD Wealth Advisors believes that these are all reasons to expect investment conditions to improve in the latter portion of 2008 and into 2009. ♦♦♦

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Estate planning sees impact of low interest rates

Low interest rates affect certain estate planning strategies. This is primarily because the value of annuities (other than commercial annuities), life estates, term interests, remainders and reversions for estate, gift and income tax purposes is determined using IRS tables pegged to an interest factor that changes monthly. As interest rates rise or fall, tax advantages or disadvantages can result depending on the planning strategy employed, as discussed below.

Grantor retained annuity trust (GRAT)

Under a GRAT transaction, the parent (grantor) contributes property to a trust and retains an annuity interest in the trust for a specified term. At the end of that term, the trust property goes to a child or other individual named at the outset. This is commonly referred to as a remainder interest. Gift tax is payable but only on the present value of the remainder interest, which is the value of the property transferred to the trust less the value of the retained annuity interest. A lower interest rate increases the value of the annuity retained by the grantor and thus reduces the value of the gift of the remainder interest.

However, if the parent dies during the trust term, the trust property will be included in his gross estate—but an individual who sets up a GRAT and dies before the end of the term would be no worse off

than if he had not entered into the transaction—except for any professional fees.

Grantor retained income trust (GRIT)

A GRIT is like a GRAT except that the grantor retains an income interest instead of an annuity interest. Tax law generally treats the grantor as making a gift of the full value of the property. A GRIT is sometimes used to pass a personal residence on to the next generation. Where a GRIT is used for this purpose, the value of the gift of the remainder is determined using IRS tables. A lower interest rate results in a lower value for the retained interest and a higher value for the gift of the remainder interest. Thus, such a GRIT is normally not tax-efficient when interest rates are low and home values are high. However, a GRIT may allow taxpayers to lock in the low value of a home during a period of lower home values.

Charitable remainder annuity trust (CRAT)

Under a CRAT, the donor retains an annuity interest and names a charity to receive the remainder at the end of the annuity term. The donor gets a current income tax deduction for the present value of the charity's remainder interest. Lower interest rates produce smaller income, gift and estate tax charitable deductions and a higher gift tax value for a gifted annuity interest.

Charitable lead annuity trust (CLAT)

Under a CLAT, the charity gets an annuity with the remainder going to a named private beneficiary. Lower interest rates result in a larger gift or estate tax deduction for the annuity interest going to the charity and a smaller value for any gift of the remainder interest going to a private beneficiary. Accordingly, low interest rates give a CLAT more appeal.

Charitable transfer of remainder interest in residence or farm

Lower interest rates result in larger income, estate and gift tax deductions for a transfer of a remainder interest in a residence or farm. ♦♦♦

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