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TRUCK TIMES

The Financial Side of the Trucking Industry

In this issue:

Fuel Hedging to Stabilize Costs

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Just a few short years ago transportation companies operated in an environment of stable fuel cost. Historically, increases in diesel costs were more closely correlated to annual inflation. There were of course the occasional spikes and drops in fuel prices requiring careful cash flow management or unexpected windfalls. In addition, growing acceptance of fuel surcharges over the years helped to greatly reduce the carriers' fuel cost risk. Therefore, trucking companies projected little or no benefit in hedging their fuel needs.

"A fuel hedge reduces the market volatility and can provide profit opportunities in an environment of fast and steeply increasing fuel costs."

With diesel costs at all time highs, record regular price increases, and uncertainty as to whether a cost ceiling or stabilization will be reached has turned attention to the fuel management strategy of hedging or negotiating fixed contract fuel cost. Hedging fuel costs allows companies to accurately budget fuel costs for the hedged period since the cost is known. A fuel hedge reduces the market volatility and can provide profit opportunities in an environment of fast and steeply increasing fuel costs.

Institutions providing energy risk management have developed multiple products to achieve the cost stability many trucking companies seek. Instruments such as swaps, call options, and collars can provide stability; however at a cost. Swaps allow locking fuel costs at a specific price. A call option places a limit for the trucking company on how high a fuel price can increase. Collars create a fuel price band or range by limiting costs above a certain level in exchange for forgoing fuel savings when pricing is below a predetermined level.

The initial decision in the process will impact the cost of setting up a hedging strategy and the premium that may be incurred. To protect against a decline in fuel usage, less than the total projected usage for the transaction time period should be hedged. However, how much, for how long and what volume at each interval must be determined. These factors and the company's financial strength will determine the total cost of the hedge transaction. Whether the hedge is priced over an average of a number of months, or is hedged by the month could also significantly impact the company's cash flow.

Hedging fuel is not without risk. An over hedge when usage is less than projected and/or the locked price is higher than the market when the fuel is consumed will result in greater fuel costs. Correlation risk also exists when the index utilized to determine the hedge price does not match as planned over the commitment period.

Fuel hedging is just one strategy for combating higher fuel cost. Specification of equipment to maximize fuel economy, driver training and equipment usage, lowering road speeds, and aggressive fuel surcharge programs remain dramatically effective methods for impacting fuel costs. •

A Small Silver Lining in the Trucking Economy Storm Cloud

By Andy Belser, CPA
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High fuel prices, excess capacity, weak demand, and recession-talk – these are the conditions in which truckers are operating today, and unfortunately, these negative circumstances directly impact trucking profits. It is evident that low profits reduce the appraised market values of trucking companies. Private fleet values are down. Merger and acquisition values are down. So what is the goods news?

Wealth Transfer

Now is a good time to get serious about any type of estate planning and wealth transfer strategies. Trucking has historically been a family-owned industry. Many trucking owners have transferred ownership of their companies to second or third generations. Of course any time wealth is transferred during life or at death; the federal government wants its share of gift or estate tax. That tax is assessed based on fair market value of the property transferred, and the tax is expensive. Often times, the tax is forty to fifty percent of the value.

"Now is a good time to get serious about any type of estate planning and wealth transfer strategies."

A common estate and gift tax planning technique is to make gifts of particular assets where there is a high likelihood of future appreciation. A subset of this strategy is to make gifts while assets are unusually depressed in value. Trucking assets are now unusually depressed in value. So naturally now is the time to consider transferring some ownership to the next generation.

Trucking performance and values have a cyclical nature. Approximately every seven years there is a downturn in the trucking economy. With every downturn, there has been a strong rebound and a return to higher profits. The early predictions for the freight market, are that capacity is being stripped from the market through bankruptcies, consolidations, and used Class 8 truck sales over seas. The expectation is that freight rates will rebound strongly with the demand versus supply shift that is anticipated.

Therefore, the estate and wealth planning strategy is to consider making gifts today while the values are down and then let the appreciation of those assets occur for children. Each person is entitled to make gifts during his lifetime of $1 million dollars without a gift tax (at death that limit increases to $3.5 million starting in 2009). Consider this brief example:

A trucking owner wants to transfer a minority stock ownership to his daughter that is valued today at $1.5 million due to market depression. It is reasonable to expect the value will increase to $2.5 million in the foreseeable future. With discounts for lack of control and marketability, the $1.5 million might be valued at $1 million for gift tax purposes. The trucking owner makes a gift of the stock to his daughter. No tax is due on the gift because it falls below the $1 million lifetime exemption. Three years pass and the stock is now worth $2.5 million. Had the gift been made at the higher value, about $285,000 of gift tax would have been owed.

Techniques such as this gifting strategy can be very beneficial in reducing estate tax liability. However, this is just a highlight of a current opportunity. Further

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Historic Fuel Prices - An Alternative Attitude

By Bruce Jones, CPA
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During the last several months, the media has been filled with reports regarding escalating fuel prices. Words like “explosive,” “uncharted territory,” “unprecedented,” “record breaking,” and “historic” with their frightful connotations have been used to describe the current situation and potential ramifications. Many suggest the prices may remain high for an extended period of time and consequently reshape fundamental activities of both consumers and businesses.

Within the trucking industry, where bankruptcies are closely correlated to diesel prices, there are approximately 1,000 business closures a quarter. Clearly, the $4+ per gallon fuel prices hardly seem to create an environment supportive of postive thinking for many business owners and executives. Yet, a closer look at the situation and a reminder of historic lessons may encourage an alternative attitude. Consider the following:

Focus of purpose is the secret of success (according to Thomas Edison) – The extreme focus driven by the suffocating prices is spawning an incredible list of new initiatives to reduce fuel consumption that will be extremely beneficial for years to come. Consider a partial list of the management actions being taken by many trucking companies as an example:

- Reduction of engine idle times
- Improvements in equipment aerodynamics
- Increased tire inflation inspections and use of wide-base tires
- Use of low-viscosity lubricants
- Use of fuel and lane optimization programs
- Lowering electronically controlled speed governors
- Installation of auxiliary power units (APUs)
- Increased use of intermodal shipping
- Real time monitoring of onboard fuel consumption dynamics
- Use of hybrid powertrain technology and biodiesel blends.

Strategic opportunity – Professor Zhang, at the Wharton School of Business, in the May 1, 2008 issue of USA Today stated “When costs increase for everybody, you get a huge competitive advantage if you do something just a little bit differently.” In other words, there are strategic opportunities currently available for those able to manage more efficiently than their competitors.

New incentives for cooperation – The common effect has started to promote new levels of cooperation. This can be seen within the trucking industry where the

annual expenditure for fuel has increased from $106 billion in 2006 to a projected $154.1 billion for 2008. The federal government (through the Environmental Protection Agency) is sponsoring and funding a partnership of shippers and freight carriers called the SmartWay Transport Partnership. The program has attracted approximately 800 partners and is growing at the rate of 30 new partners a week. Both shippers and carriers are encouraged to implement a list of fuel saving initiatives, some that are interdependent, gaining not only cost savings, but also national recognition for environmental improvements and progressive leadership. In another example, recently a logistics company held a shipper symposium near the headquarters of Wal-Mart. It approached approximately 120 shippers (including Wal-Mart) and motor carriers to discuss not only how to deal with the high fuel prices, but also how to lower greenhouse gas emission levels.

National Initiatives – Increasingly, industry associations are actively requesting federal government assistance to promote needed changes. Consider the American Trucking Association’s recent request of the federal government:

- Stop filling and instead release oil from the Strategic Reserve
- Establish a national diesel fuel standard

Continued on page 7. See “*Alternative Attitude.*”

Section 1031 Exchange: Deferring the Tax Payment

By Chris Cox, CPA
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In a typical sale transaction, a property owner is taxed on the gain from the sale or exchange of property unless a specific exception or rule under the IRS Code provides otherwise. One popular method used to defer the tax consequence resulting from the sale of property is the use of IRS Code Section 1031 (Like-Kind Exchanges) which governs the rules related to like-kind exchanges. Many people typically think of using like-kind exchanges when entering into real estate transactions. However, a like-kind exchange can be very effective in transactions involving the selling and exchanging of personal property. This can be a significant benefit to a trucking company that is replacing tractors or trailers.

The theory behind a like-kind exchange is that when a property owner has reinvested the sale proceeds or exchanged into another property, the economic gain has not been realized. Therefore, it would seem to be unfair to force the taxpayer to pay tax on a "paper" gain. Of course, when the replacement property is ultimately sold (not as part of another exchange), this ends the deferral period and the tax then becomes due. The tax recognition could occur many years after the deferral period began.

"...a like-kind exchange can be very effective in transactions involving the selling and exchanging of personal property."

Properly structured, a 1031 exchange will postpone the gain and related tax burden as long as the taxpayer holds replacement property. It is one of the few techniques available to postpone tax due on the sale of qualifying property. Another way to view a like-kind exchange is as an interest free loan from the government, in the amount of the unpaid tax. Consider the sale of fifty tractors that are fully depreciated for tax purposes at an average sale price of $50,000 per unit; this represents a tax gain of $2.5 million. If your average tax rate is 40% you are deferring a tax obligation of $1 million.

Different types of exchanges

A 1031 exchange will fall into one of the following types:

Simultaneous Exchange: The exchange of the relinquished property for the replacement property occurs at the same time.

Delayed Exchange: The exchange occurs when there is a time gap between the transfer of the relinquished property and the acquisition of the replacement property. These exchanges are subject to strict time limits. Generally, the taxpayer must identify the replacement property or properties in writing to the qualified intermediary within 45 days of the relinquished property's sale. In addition, within 180 days of transfer of the relinquished property, the taxpayer must receive the replacement property. The 180-day period is limited to the due date of the taxpayer's tax return unless the return is extended.

Reverse Exchange: A situation where the replacement property is acquired prior to transferring the relinquished property. These exchanges are also subject to similar strict time limits.

There are several requirements and guidelines that absolutely must be followed in order for the transaction to qualify for the deferral treatment. Failure to follow the very strict and complex rules and regulations could result in gain recognition if challenged by the IRS.

While this type of transaction can be very beneficial it may not be appropriate in every circumstance. Prior to entering into any significant equipment transaction careful analysis and thought should be given to the relevant facts and a decision made based on what is best for the business. •

To Outsource or Not to Outsource..... That is the Question

By Chris Felger, CPA
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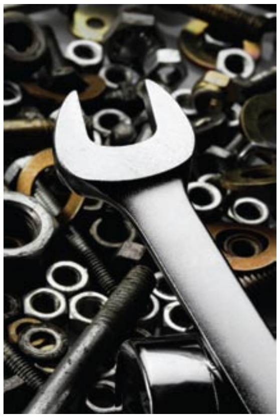
Companies in all industries, non-profit organizations, and governmental agencies at all levels have been significantly impacted by rising operating costs in the last twenty-four months. The transportation industry is no exception and has been much more drastically impacted by rising fuel costs.

Outsourcing fleet maintenance may be an opportunity to reduce costs while allowing the company several other benefits. Three important considerations when evaluating outsourcing of any kind are the opportunity for cost reduction, the opportunity to reduce or eliminate non-value added processes, and the opportunity for risk transfer related to the outsourced activity to the vendor.

"Outsourcing fleet maintenance may be an opportunity to reduce costs while allowing the company several other benefits."

Fleet maintenance vendors generally have access to highly skilled labor and superior parts purchasing power that cannot be accessed by the many transportation companies. When evaluating the potential for cost reduction, expenses other than the direct labor and materials related to the fleet repairs need to be considered. Potential cost reductions also include expenses such as employee benefits, training, liability and workers' compensation insurance, supervisory time, building and equipment maintenance, and other shop related expenses. Outsourcing allows companies to react quicker to changes in their business with significantly less financial risk because the expenses that were once fixed or semi-fixed are now variable.

The cost of having working capital tied up in inventory, supplies, tools, diagnostic equipment, buildings, and other assets should also be considered. Outsourcing may allow a company to spread certain maintenance costs over the course of a year depending on the type of contract which may result in improved budgeting and more predictable cash flows.



Outsourcing fleet maintenance may create opportunities to streamline, reduce, or eliminate non-value added internally focused processes and procedures. Consideration should be given to what customers perceive as valuable and what are the necessary steps in the delivery of services. Outsourcing may be an opportunity to reduce the associated costs of these activities.

Common examples of non-value added activities related to fleets include resources devoted to tracking compliance with a preventative maintenance program, resources devoted to tracking repair costs, maintaining an inventory of supplies and parts to perform repairs, mechanics that are not fully utilized and productive, repair failures and the associated rework and the related costs. Many fleet maintenance vendors have internet-based preventative maintenance program tracking, cost tracking by unit and failure type, budget-to-actual fleet maintenance expense comparisons, exception reporting, and key metrics analysis that may assist in streamlining internal analysis of fleet management and make this process more efficient and more meaningful for decision making.

There may be opportunities to contractually transfer unwanted risks when outsourcing repairs to a fleet maintenance vendor. These risks may relate to performing the repair or the consequential or incidental damages related to the repair performed if the unit is subsequently involved in an accident. The opportunity for this risk transfer would depend on the risk tolerance of the parties involved and the contractual opportunity to transfer such risks in varying legal jurisdictions. Consult with experienced legal counsel to determine if these opportunities should be incorporated into a risk management plan.

Outsourcing has become popular in recent years with many companies outsourcing business functions in an attempt to reduce costs and focus on their core business. The true cost and benefits must be carefully considered and continually reevaluated as business conditions and the economy changes. A fleet maintenance vendor should be viewed as a trusted business partner and expected to bring value-added strategies to the table related to the fleet management function. The timing may be opportune to evaluate outsourcing fleet maintenance and negotiate favorable rates and contract terms, given that many fleet maintenance vendors currently have excess capacity similar to the rest of the transportation industry.

Alternative Attitude *(continued from page 5)*

- Allow environmentally responsible development of crude resources
- Work with all state attorney generals to combat any price gouging
- Continue to fund the EPA's SmartWay Transport Partnership program
- Streamline regulatory framework for refinery applications
- Require speed limiters set for 68 mph or lower on all new trucks
- Set a national maximum speed limit of 65 mph
- Suspend collection of 12% excise tax on auxiliary power units to promote their use
- Close federal loophole that provides a tax benefit for the exportation of biodiesel.

In summary, while current fuel prices pose severe challenges for many, perhaps these prices will also bring needed changes and opportunities for those with an alternative attitude.

This article was contributed by KSM Transport Advisors, a separate entity, providing transportation consulting services. Katz, Sapper & Miller LLP and KSM Business Services, Inc. are not responsible for the contents of this article, or any changes or updates. For more information about KSM Transport Advisors, please call Bruce Jones at 317.580.2324.

Silver Lining *(continued from page 3)*

consideration of this strategy should be undertaken with the a tax advisor.

Selection Planning

For those trucking companies that are structured as regular corporations and have considered the conversion to Subchapter S status, now is a good time to take a serious look at the strategy. The primary tax benefit for an S corporation owner is the elimination of the "double tax" on corporate earnings. S corporation stockholders do not pay a second tax on distributions of profits. However, dividends of profits from a regular corporation are taxed a second time to the stockholder.

One of the huge hurdles in managing a conversion to S status is the "built-in-gains" tax. This tax is designed to capture the double tax effect on newly elected S corporations on assets acquired before the S election. The tax is determined based on fair market valuations of assets. For this purpose, if the valuation of the assets are low or depressed, then the possible built-in-gains tax will be lower.

With trucking company assets being extraordinarily low in current valuation, now may be a good time to consider an S election for your trucking company. There are several other tax benefits to being an S corporation compared to a regular corporation. If the idea is of interest, now is a good time to execute the strategy. Of course, please consult a tax advisor for a thorough analysis of the situation.

In summary, even though these strategies will not improve operating ratios, they quite possibly could add to after tax cash flow and family net worth.

Here and There in the Trucking Industry

Tim Almack was re-elected to the Truckload Carriers Association Board of Directors and the Kentucky Motor Truck Association Board of Directors.

Tim Almack attended the Kentucky Motor Truck Association Board of Directors Meeting in March 2008.

Andy Belser attended the National Accounting and Finance Council Convention in March 2008.

Chris Cox and Jason Miller attended the Illinois Trucking Association's Trucking Industry Political Action Committee (TIPAC) Golf Outing in July 2008.

Chris Cox and Ed Sullivan attended the Indiana Motor Truck Association's TIPAC Golf Outing in August 2008.

Mark Flinchum attended the Tennessee Trucking Association meeting in September 2008.

KSM's Committment to the Trucking Industry:

- American Trucking Association
- Illinois Trucking Association
- Indiana Motor Truck Association
- Kentucky Motor Truck Association
- National Tank Truck
- Ohio Trucking Association
- Truckload Carriers Association
- Tennessee Trucking Association

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