

A newsletter for closely-held businesses, their owners and advisors

**Message From
 The Firm**

There has recently been an upturn in the economy. As a result, we have seen an increase in business transactions, in particular, more mergers and acquisitions and more real estate transactions. Hiring shortages are also requiring companies to be more creative in their equity-based compensation in order to attract and retain good employees. In addition, employees are starting up their own businesses, which raises issues of trade secret protection and unfair competition. Finally, recent tax law changes encourage investment in new equipment.

The articles included in this newsletter address many of the issues mentioned above. Adam Cohen and Lee Reicher discuss in their article the need for borrowers to carefully review and negotiate the letter of intent in real estate financing deals. Mark Terman's article presents a situation in which a company uses a compensation package to entice a key employee to remain loyal. Robin Gildea's article highlights ways in which a business can receive a tax savings through bona fide sale, disposal or charitable donation of excess or obsolete inventory. Nelson Handy encourages employers to review all pre-January 28, 2002 split-dollar insurance agreements for potential adverse tax implications before the December 31, 2003 deadline.

As always, if you have any questions or comments, please contact me or one of the attorneys who has written an article.

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COMMERCIAL REAL ESTATE FINANCING

The Importance of a Detailed Letter of Intent

By Adam Cohen (AdamCohen@Reish.com) and Lee Reicher (LeeReicher@Reish.com)

While we represent both borrowers and lenders, this article addresses the issues from the viewpoint of the borrower.

Problem: As a condition to obtaining a loan secured by commercial real estate, the lender generally requires the borrower to sign a "Letter of Intent." Blinded by the fear of rising interest rates and the promises of low closing costs, the borrower quickly executes the Letter of Intent to get the loan process started. Should the borrower just check the interest rate and the dollar amounts before signing the Letter of Intent, or is this a document that should be carefully reviewed and negotiated?

Solution: The Letter of Intent is a very important document that "locks in" many critical deal points and ideally, it clearly spells out the borrower's rights and obligations with respect to the loan. Although the Letter of Intent is non-binding, it is still crucial to negotiate these points at this stage, because it becomes more difficult, if not impossible, to negotiate them later. Keep in mind that what is practical and appropriate will vary from transaction to transaction and will depend on the size, nature and timing of the loan, and the relative bargaining strength of the parties. The following are examples of some of the issues that must be carefully reviewed in the Letter of Intent:

1) Fees and Deposits. The borrower is generally required to pay a substantial application and commitment fee and a good faith fee or deposit at the time the commitment is issued. Make sure that the Letter of Intent

specifies that the foregoing fees/deposits are refunded if the loan does not close for any reason beyond the borrower's reasonable control. If the lender will not agree, the borrower should request that the nonrefundable fees/deposits constitute liquidated damages, so that the borrower can walk away from the loan with fixed damages.

2) Legal Opinions. In most loan transactions, the lender will require one or more legal opinions, but the commitment may require nothing more than "such opinions as the lender may reasonable require." Make sure that the Letter of Intent contains a sample opinion letter that the lender requires. Legal opinions can be expensive and it is better to flush out at the Letter of Intent stage any opinions that cannot be legally or factually supported rather than finding out the day before the closing.

3) Reserves. In most loan transactions, the lender will require the borrower to set aside funds for various expenses, most typically taxes and insurance, but sometimes also for costs of major repairs, replacements, leasing costs, lease termination payments and environmental remediation costs. Since these reserves can disrupt your future cash flow

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Letter of Intent

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projections, try to negotiate the Letter of Intent such that the lender will waive tax and insurance impounds until an event of default occurs. If the lender will not agree, the borrower should request interest on these funds.

4) Insurance. In every loan transaction, the lender will require the property to be adequately insured; this generally forces the borrower to obtain at least the following types of insurance policies: “all risk” casualty, comprehensive commercial general liability, business interruption, workman’s compensation and general boiler and machinery. Make sure that the type and amounts of the insurance are clearly stated in the Letter of Intent and review them with your insurance agent. We have seen many borrowers shocked at the cost of insurance premiums when they waited until the end of the process to check the coverage requirements that are normally contained in the Letter of Intent.

5) Subordinate Financing/Assumability. While nearly every lender will prohibit any sale or transfer of the property that secures the loan, some lenders will even prohibit subordinate financing and impose burdensome rules and procedures for having a third party assume your loan. You should know whether or not you can obtain subordinate financing from the start; as a prudent borrower, you want to keep as many exit strategies open as possible.

Benefit: Careful review of the Letter of Intent will set the “deal points” for the commercial loan transaction, speed the process of reviewing the loan documents, and help avoid surprises at a time when it is too late to renegotiate the loan terms. Note that the foregoing examples in this article are just the tip of the iceberg. You will also want to negotiate other aspects of the Letter of Intent, such as prepayment penalties, non-recourse provisions, change of control provisions, reporting requirements and default rates of interest. The more you know up front, the fewer surprises you will encounter and you will have more leverage with your lender. ❖

The Devil You Know: Keeping Employees from Competing Unfairly

By Mark Terman (MarkTerman@Reish.com)



Problem: A national sales manager of a large manufacturing and importing client resigned under the false pretense that he was taking a job outside the industry. We investigated and proved that the employee had stolen our client’s trade secrets and went to work for a direct competitor. We were poised to crush the former employee, and possibly his new employer, in unfair competition litigation. Our client, however, chose to use that leverage to rehire the employee and asked us to figure out a way that would make it difficult, if not impossible, for the employee to repeat his misconduct in the future.

Discussion: When the employee announced his resignation, our client was hoping to retain the employee (whose work had been exceptional) and it mistakenly took no additional protective measures regarding its trade secret information—such as locking the employee out of the computer system, retrieving files from the employee’s office, and reasonable searches of materials the employee sought to take out of the company when he left.

The employee literally cleaned out his office over the weekend after his last day of employment. By Monday morning, not a single piece of paper was left in the former employee’s office. The client called us. We sent in a computer forensics expert to recover “deleted” e-mail files and to pick up the trail of computer data downloads. We asked our client’s CEO to call its major customers and key suppliers to inform them who in senior management would be their new contact, to assure them that the company valued their business relationships, and to simply listen. These two methods revealed that the former employee was now the National Sales Manager of a direct competitor and that he had taken and was disclosing our client’s trade secret information including a new product line, purchasing history and order needs, and supplier sources and pricing. As is common in these

kinds of cases, none of the customers or suppliers wanted to sign statements or get involved in litigation. Our client was also reluctant to commence litigation.

We sent our private investigators to the first big trade show of the season posing as industry buyers. Over two days at the show, our investigators befriended the former employee who was running the competitor’s booth at the show. The former employee confidently and freely disclosed to these “buyers” how he had taken our client’s trade secrets and that there was not much our client could do about it. We confronted the employee with our investigator’s reports and his trail of e-mails and computer data under threat of litigation, as we believed we had enough proof to win an unfair competition lawsuit against him and possibly his new employer. We were in for two surprises.

First, the employee unexpectedly pled for his old job back. (We counseled our client about whether it could ever really trust this person again.) Second, and even more surprising to us, our client asked us to figure out a way that would make it difficult, if not possible, for the employee to repeat his misconduct in the future if he was rehired.

Solution: California law permits covenants not to compete (CNC) during employment but does not permit a post-employment CNC, except in limited instances such as when the company buys shares, including goodwill, back from the employee/shareholder. Our client was not about to give the employee stock in the company; but, it was convinced that the employee could grow the client’s sales exponentially if given incentives to do so.

Our solution was to “buy” the employee’s “honesty.” We created a large contingent

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Competing Unfairly

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bonus program based on company-wide and the individual's sales performance where a small portion would be deemed earned and vest in the current year, and the balance would be deemed earned and vest over the next two years unless the employee quit or was terminated for cause. We also included an "employer friendly" definition of "cause." This system essentially held a carrot out in front of the employee so that he would give up too much money if he quit again.

When unfair competition is suspected, employers must engage experienced counsel to act quickly and practically...

In addition, we drafted the employment agreement to include strict confidentiality and trade secret rules, post-termination non-solicitation of employees, customers, and suppliers provisions (which are enforceable), a during-employment CNC, and "work-for-hire" provisions which confirm that all inventions and other intellectual property created by the employee as part of his work belong to the employer.

Benefit: When unfair competition is suspected, employers must engage experienced counsel to act quickly and practically—that may entail filing a lawsuit or a restraining order immediately it may require investigating over a brief period of time to collect information that locks in the proof needed to win a lawsuit. In this case, the immediate investigation paid off. In resolving this matter, we thought "outside the box" for a client who took the unusual step of rehiring a key employee whose honesty was dubious. Ultimately, we helped our client overhaul its company-wide protection programs for its trade secrets, computers, and other essential business assets. ❖

Excess or Obsolete Inventory Can Lead to Tax Savings

By Robin Gilden (RobinGilden@Reish.com)



Problem: A business with obsolete, overstocked or otherwise unsalable inventory that is written-down or off their books for financial accounting purposes, assumes it can take a deduction, for federal income tax purposes, in an amount equal to the book write-down. However, according to the Supreme Court, a taxpayer is not entitled to a deduction until the taxpayer has sold or otherwise disposed of the inventory. How should a business take a deduction for excess or obsolete inventory?

Solution: There are three possible ways that a business can claim a tax deduction on excess or obsolete inventory: 1) a bona fide sale, 2) destruction of the inventory, or 3) donation to an appropriate charity.

Inventory Purchasers are entities whose principal business consists of buying obsolete or overstocked inventory from other businesses. In order for a sale to an Inventory Purchaser to be deemed bona fide, the purchase agreement must provide that if the seller repurchases the inventory from the Inventory Purchaser, the purchase price will be equal to the fair market value of the inventory at the time of the repurchase. Often the terms of the sale to the Inventory Purchaser include terms that would likely result in a taxing authority concluding on audit that the sale was not bona fide. For example, the Inventory Purchaser will purchase the inventory for its depressed price, agree to maintain the inventory for some time period and sell it back to the business for the same price that the Inventory Purchaser paid for it, regardless of the value of the inventory at the time of the buy back.

If a business wishes to claim a deduction on the destruction of obsolete, or overstocked inventory, it should carefully document the destruction such as taking before and after pictures.

Sometimes inventory that is unsalable in the marketplace will nonetheless have a fair market value in excess of a business' tax basis in the inventory. Under Section 170 (3)(e)

of the Internal Revenue Code (the "Code"), a corporation, other than an S corporation, can receive a charitable contribution deduction equal to the lesser of (a) the fair market value of the inventory on the date of transfer to a charity reduced by one-half of the gain that would be recognized if the inventory were sold or (b) two times the taxpayer's tax basis in the inventory if the following requirements are met: (1) the donation is to a charitable organization described in the Code; (2) the use of the property by the charity is related to the purpose or the function constituting the basis for the charity's exemption from tax under the Code; (3) the gift is to be used by the charity solely for the care of the ill, the needy or infants (under the age of 18); (4) the charity does not transfer the inventory in exchange for money, property or other services; (5) the taxpayer receives a written statement from the charity representing that the use and disposition of the inventory would be in accordance with (2), (3) and (4).

Benefit: A business can claim a tax deduction for obsolete or otherwise unsalable inventory by following one of the methods described in this article. The deduction amount depends on the method chosen. Through a bona fide sale, a business should be entitled to claim a deduction equal to the excess of the business' tax basis in the inventory (generally its cost) over the purchase price that the taxpayer receives for the inventory. Upon destruction, a business should be entitled to claim a deduction equal to the business' tax basis in the inventory. If the inventory is donated in accordance with the rules listed above, a business can receive a deduction in excess of its cost. A corporate taxpayer's charitable contribution deduction is limited to five percent of its net taxable income. Charitable contribution deductions that cannot be utilized due to the limitation can be carried forward indefinitely until it can be used. ❖

LIFE INSURANCE ALERT

Last Chance to Terminate or Convert Split Dollar Insurance Arrangements Before the Expiration of Safe Harbor

By Nelson Handy (NelsonHandy@Reish.com)

All pre-January 28, 2002 split dollar insurance agreements must be reviewed immediately and the income tax, gift tax and employment tax implications of those agreements ascertained in light of a safe harbor for terminating such agreements or converting to a loan by December 31, 2003.



For almost 30 years, the IRS had been relatively silent on the tax treatment of split-dollar insurance arrangements. Then in 1996, the IRS began a series of statements and retractions that ultimately ended with the issuance of a significant Notice in February 2002 and the adoption of final regulations in September 2003.

Concurrent with the issuance of the final regulations applicable to split-dollar arrangements, the IRS issued Revenue Ruling 2003-105. This revenue ruling provides the latest guidance on the taxation of split-dollar life insurance arrangements. Revenue Ruling 2003-105 provides as follows:

- 1) Treasury Decision 9092 issued new regulations. These regulations directly apply to split-dollar life insurance arrangements that are entered into after September 17, 2003 or any existing split-dollar arrangement that is materially modified after September 17, 2003.
- 2) Various prior revenue rulings were declared obsolete, including RR 64-328.
- 3) For pre-September 17, 2003 split-dollar arrangements, taxpayers may continue to rely on Notice 2002-8 (and to the otherwise obsolete revenue rulings to the extent provided in Notice 2002-8).

The purpose of this alert is not to describe how new arrangements should be constructed, but to describe rules and options applicable to existing arrangements pursuant to the guidance provided in Notice 2002-8.

In Notice 2002-8, the IRS provided rules for valuing life insurance protection and provided four specific transition rules that would apply to any split-dollar arrangement entered into prior to the date of the issuance of final regulations applicable to split-dollar arrangements. However, the last transition rule only applies to split-dollar arrangements entered into prior to January 28, 2002.

Valuing Life Insurance Protection

For many years, the income tax focus for split-dollar arrangements was the determination of the value of the annual insurance benefit. The annual insurance benefit is comparable to the cost of a one-year term life insurance policy. For many years, the determination of annual insurance benefit was derived from an IRS schedule commonly referred to as PS 58 or possibly a lower value issued by the insurance company. The IRS determined that the old PS 58 values required updating because of the changes in mortality risks over the past 45 years. A new table to replace PS 58 was set forth in Notice 2001-10 (although the old PS 58 rates will be applicable to arrangements that specifically require that rate). As to values provided by insurance companies, the IRS now requires that the values be "published premium rates that are available to all standard risks for initial issue one-year term insurance." The IRS added special rules to confirm that such rates are actually available.

Rule #1: IRC Section 83 Inapplicable

Under the first transitional rule, the employee will not be taxed on any policy equity accruing from interest or dividends that increases

the equity in the portion of policy that is not to be repaid to the employer. A simple example is as follows: an employer has paid \$500,000 in premiums on a policy held by a trust created by the employee. The employer is entitled to receive the premiums back upon termination of the arrangement or death of the insured. In year 5, the cash value is \$600,000 and the cash value is increasing at \$20,000 per year. Under this transitional rule, each year as the trust's share of the cash value of the policy increases, the employee will not be treated as having received any taxable income under IRC Section 83. However (except as discussed below), the employee would still be taxed on this amount if the plan is terminated or the funds are borrowed from the policy. Continuing a split-dollar plan under this transitional rule results in a plan without an exit strategy (other than the death of the insured).

Rule #2: Terminated Plan Without Recognizing Transfer of Assets

If a split-dollar arrangement is terminated, but value of the life insurance protection continues to be recognized as income, the IRS will not assert that there has been a transfer of property to the benefited person by reason of termination of the arrangement. Accordingly, under this option, the employee will continue to include in income the annual value of the current life insurance protection. The negatives of this option include:

- 1) The annual income to be recognized can become quite high as the insured ages.
- 2) The company probably would not be entitled to an income tax deduction for the income recognized by the employee.
- 3) If the owner of the policy is a trust, the employee will likely be treated as making gifts to the trust for the value of the life insurance protection.

Rule #3: Treatment as a Loan

Under this option, the amount owed to the employer can be treated as a loan. Although somewhat ambiguous, guidance we have received indicates that this transitional rule only approves the conversion to a loan and treatment as a loan (whether occurring in the past or the future). However, this transitional rule does not protect against other income

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Life Insurance

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tax consequences that could arise upon termination of the arrangement.

This transitional rule requires that all employer outlays for premiums must be picked up as the beginning loan balance at the beginning of the taxable year in which the treatment as a loan began. These loans may be interest-free or low interest loans and taxed under Internal Revenue Code (IRC) Section 7872 and Sections 1271-1275.

Rule #4: Safe Harbor for Termination of Arrangement

Under the last transitional rule, a safe harbor for the termination of insurance arrangements is provided. However, this safe harbor is only available to split-dollar arrangements entered into before January 28, 2002. The critical components of this transitional rule are as follows:

1. If there is a pre-January 28, 2002 split-dollar arrangement and the sponsor is

owed a refund of all payments made (less refunds already received)

2. the IRS will not assert that there has been a taxable transfer of property to the benefited person upon termination of the arrangement if either (i) or (ii) applies
3. (i) the arrangement is terminated before January 1, 2004
4. (ii) for all periods beginning on or after January 1, 2004, all unrefunded payments by the sponsor from inception of the arrangement are treated as loans for Federal tax purposes, and the parties to the arrangement report the tax treatment in a manner consistent with this loan treatment, including IRC Sections 1271-1275 and IRC Section 7872. Any such payments by the sponsor before the first taxable year in which such payments are treated as loans for Federal tax purposes must be treated as loans entered into at the beginning of that first year in which such payments are treated as loans.

The loan treatment under transitional rule #3 and the loan treatment under transitional rule #4 have two different purposes. Under

transitional rule #3, loan treatment is approved for all existing split-dollar arrangements, but transitional rule #3 does not provide any special protection from recognition of gain if the arrangement is terminated. Under transitional rule #4, if the arrangement is a pre-January 28, 2002 arrangement (with certain other attributes) and it is converted to a loan prior to January 1, 2004, upon later termination of the arrangement the IRS will not assert that there has been a transfer of property.

Summary

Because the safe harbor for terminating arrangements created before January 28, 2002 or converting them to loans on a tax favorable basis only lasts until December 31, 2003, it is important to identify existing split-dollar arrangements and perform the analysis necessary to determine whether any actions should be taken. ❖

Around the Firm

Michael Foster and David Schwartz co-wrote an article for the October issue of *California CPA* on "Final Regs Issues on Election to Treat Revocable Trusts as Part of Estate." Mark Terman's article on "Employment Discrimination Ruling Carries Many Lessons" was published in the September issue of *California CPA*. Lee Reicher's article on "Payout to a Retiring Partner" appeared in the September issue of the *Los Angeles County Bar Update*. Robin Gilden and Kalyani Chirra co-authored an article in the August 14th issue of the *Los Angeles Daily Journal* on "Deductibility of Medical Expenses, Premiums Depend on Entity Type." Mark's article on "How to Fire an Employee Without Getting Sued" was published in the August 15th issue of the *Los Angeles Daily Journal*.

Jon Karp was a speaker at the California CPA Education Foundation's High Net Worth Individuals Conference in Los Angeles and San Francisco in November on "Selected Exit Strategies for Owners of Closely-Held Businesses." Mark chaired the Foundation's 2003 Employment Law Conference in Irvine on October 28th and in San Francisco on November 12th, and was a speaker at the conference on "Technology, Privacy and Confidentiality in the Workplace." Mark also spoke at the Foundation's Management of an Accounting Practice Statewide Conference in Los Angeles and San Francisco in September on "Hot Employment Law Topics that You and Your Clients Need to Know About." Brad Cohen was a member of the planning committee for the 2003 Entertainment Industry Conference on September 23rd.

David Schwartz has been appointed Secretary for the Entertainment Tax Council of the LA County Bar. David will assist in organizing continuing education programs for the Council and will be preparing a position paper that will be presented to the Joint Committee on Taxation in Washington, D.C.