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VALOREM PRINCIPIA

The Principles of Value

Volume 12 Issue 1 February 2004

AVOID TAX FINES WITH FORM 709!

by: Forrest Vickery and Tracy Washburn

The April 15 tax deadline is fast approaching, and taxpayers are scrambling to submit voluminous forms, receipts, and information on their financial activity to their accountants or whomever assumes the responsibility of filing their taxes. Those completing tax forms should be fully aware of the taxpayer's financial activities during the year, as there may be areas that require additional filings unknown to the taxpayer.

For example, during the course of the year, an individual may have given away assets or money to one or many persons, which could result in federal gift taxes imposed on the donor's estate. If the donation is taxable, a Form 709 must be filed with the IRS, and tax fees may arise depending on the amount gifted. Although gift taxes do not affect most taxpayers nearly as often as income taxes, gift tax payments are real and can be significant; realizing what constitutes a gift, what forms should be filed with the IRS, and whom to consult when assessing or creating a gift or estate plan can prevent unnecessary time and energy spent on tax issues.

TAXABLE GIFTS

A gift tax is applied when a person donates money or property to someone else, and the value of the gift exceeds the permitted amount designated by the IRS. The gift tax is never imposed upon the person receiving the gift. The donor will not have to pay taxes so long as the gift remains within the given taxable exclusion amounts. In 2004, an individual may gift up to $11,000 to one or more persons in a given calendar year (i.e., annual exclusion), and up to $1,000,000 during one's lifetime (i.e., lifetime exclusion) without having to notify the IRS. If, however, the gifts exceed the allotted IRS exclusion amounts, a gift tax return (Form 709) must be filed. While most donors will not have to pay a tax, if the gift is a very large sum, a tax will be levied based on tax rates for that particular year (e.g., as high as 48% for 2004).

For a gift to be considered taxable, the donor must have "so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or the benefit of another".

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Buy-Sell Agreement - A Business Partner's Prenup

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In deciding to own a business with others, we spend most of our time determining what is the most appropriate form of ownership (e.g., a corporation, a limited liability company, etc.) and the amount of our investment and ownership interest. However, it is just as critical to determine how to extricate yourself from the business with your value intact or to be able to remove your business partner if necessary without harming the business in the process. The mechanism to best achieve this is a buy-sell agreement.

Buy-sell agreements go by a variety of names-buy-sell agreements, buy-out agreements, transfer restriction agreements, etc. The important factor is not its name but that the agreement deals with events that will trigger either an opportunity or an obligation for the company or the owners to buy out the equity of another owner. In this respect, the buy-sell agreement acts as a type of pre-nuptial agreement in a business setting, as well as an estate and succession-planning tool.

Ordinarily buy-sell agreements work best with closely held companies in which many, if not all, of the owners are employed by the company. Without a buy-sell agreement, the company could not prevent ownership from being transferred to outsiders.

Although for convenience in this article, I refer to corporations and shares, the same would apply to partnerships and limited liability companies. Also, unless otherwise noted, C and S corporations are similarly treated and can equally benefit from buy-sell agreements.

Typically, buy-out events include:

- an attempted voluntary transfer of the shares;
- death of a shareholder;

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For example, when a gift is made for the purpose of establishing a trust for a young child to be payable only on the child's 25th birthday, and the owner relinquishes his or her dominion and control over the subject property, the gift is considered a "Future Interest," which is taxable. Form 709 would then have to be filed by April 15th of the year following the gift, irrespective of the gift's value.

Gifts Not Considered Taxable

A person can make $11,000 gifts to as many different people in a year as she or he likes with no tax consequences to the donor, and the donor will not have to file Form 709 with the IRS. Spouses can gift any one individual a total of $22,000 per year (two times the $11,000 limit) without gift tax consequences. The latter is referred to as "gift splitting", wherein husband and wife can treat a gift by one of them as if half were given by each one. If one spouse gifts $22,000 to someone and gift splitting is not elected, however, the IRS can treat that as a $22,000 gift by one spouse, even if the funds are drawn from a joint account. The married donors then must file Form 709 and may incur taxes. If each writes a separate check, however, the couple will be exempt from taxation, as each has effectively given $11,000. Gifts are classified as either present or future interest gifts. A "Present Interest" gift is a gift to an individual that is available for immediate use. For example, a father could give $11,000 in cash to each of his children once a year, deeming the money free for spending, saving, or whatever the child wishes to do with it immediately upon receiving the cash. A future interest gift, however, is a gift for which immediate benefits will not be available for the donee (i.e., a trust for which a ten-year old child will not have access to the assets until a later birthday). Additionally, gifts that are made for tuition costs or medical expenses are not subject to the annual or lifetime exclusion amounts and are not considered taxable. This is important if a donor is interested in making gifts but has reached the maximum annual amount on tax-free gifts.

FORM 709

It is only necessary to file a gift tax form if the total amount of the gift exceeds the $11,000 allotted yearly limit, if a person gifts past the lifetime exemption amount, or if the gift is made as a future interest gift. The following are some examples using a fictitious married couple, Sean and Sara, and their children, Scott and Katia.

Example 1: Sean wants to transfer money to his children every year from his estate. His accountant sets up a plan that gifts $11,000 per year to Scott, and $11,000 per year to Katia. Because his donations remain within the $11,000 exclusion amount per person per year, and are transferred in cash as 'present interest' gifts, Sean does not have to file a Form 709 with the IRS.

Example 2: Sean wants to decrease the size of his and his wife's estate, and transfers personal bonds valued at $11,000 each to his seven brothers and Sara's three sisters. Although the cumulative total of these gifts is $110,000, he will not have to file with the IRS because the individual totals did not exceed the annual exclusion amount for gifts to individuals within a given year.

Example 3: Sean and Sara set up a trust for Scott when he is an infant, declaring that Scott cannot access the $10,000 inside the trust until he reaches his 21st birthday. Although the sum of the gift is less than the exclusion amount necessary to bypass taxation, they have donated a gift of future interest to Scott, which requires them to fill out a gift tax return on the $10,000 in the trust.

Plan For Success

To avoid costly taxes in the future, have a plan in place early on for the succession of an estate and gifts within that estate. The following are a few suggestions estate planning professionals have made when organizing a plan for the future:

- Make gifts for the year on January 1, before anything can happen to the owner of the estate.
- Take action during the entire lifetime of the individual to reduce the value of the property owned, such as giving away percentage interests in assets owned by the estate.
- If a gift tax return is necessary, it is important to file the forms annually, therefore keeping current on all developments within the estate for the year.

There are several key questions to ask potential estate or gift tax consultants during the selection process, including:

- For business valuation consultants: Do they have the proper credentials required to withstand third-party scrutiny, such as the Accredited Senior Appraiser (ASA) designation from the American Society of Appraisers?
- For an accountant: Do they have prior estate and gift tax filing experience?
- For an attorney: Do they have experience with taxation issues involving a person's estate and the gifts that are permitted during a person's lifetime?
- For all consultants: Do they have previous experience working with IRS audits, and have they been involved with trials involving these issues?

Form 709 is a significant part of gift taxes and estate tax planning. It is important to consult an expert early on in estate and gift tax planning to ensure the correct methods and procedures are used, and the right forms are filed when necessary. Furthermore, an expert planner can save the owner of an estate from exposure to unnecessary potential taxes and penalties.

[1] **Treas. Reg. §25.2511-2 (b)**

Sanli Pastore & Hill, Inc. is not providing tax advice in this article. It is the responsibility of the taxpayer and his or her advisors, attorneys, accountants, and/or valuation professionals to determine the appropriate gift and estate plan that complies with IRS rules and regulations. For more information on Form 709, or Estate and Gift Tax Planning, contact Forrest Vickery, ASA, at 916-614-0530, or Tracy Washburn and Tom Pastore at 310-571-3400.

SP&H is thankful to Andrew Katzenstein, Partner of Katten Muchin Zavis Rosenman, and Michael Owen, of Boyle & Owen CPAs, for their contributions and assistance with this article. Mr. Katzenstein works in the areas of employee benefits and executive compensation, tax planning and litigation, and trusts and estates within KMZR's Los Angeles and Palo Alto offices. He can be reached at 310-788-4540. Mr. Owen is an accountant in the area of estate tax and gift tax planning at Boyle & Owen's San Fernando Valley office, and can be reached at 818-994-2200.

NEWSFLASH

December 6th - Beverly Hills, California
29th Annual Beverly Hills Bar Association Family Law Symposium
SP&H was an Exhibitor at this event.

January 15th - Orange County, California
Current Trends in Private Company Valuations - presented by Harvard Business School Association of Orange County and Sanli Pastore & Hill, Inc.
SP&H sponsored this event and Nevin Sanli was a panelist.

March 10th - 12th Monterey, California
CRA Conference and EXPO
SP&H will be a Presidential Exhibitor.

April 1st San Francisco, California
ACG San Francisco and Haas Business School - Private Equity Conference
SP&H will be an Exhibitor.

May 10th - Irvine, California
Harvard Business School Entrepreneur Conference
SP&H will be sponsoring this event and Nevin Sanli will be presenting "Buy, Build & Sell".

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- disability of a shareholder;
- termination of employment/retirement of a shareholder;
- bankruptcy of a shareholder; and
- divorce of a shareholder.

For each buy-out event, the company and the shareholders must decide whether the event will trigger a mandatory buy-out or an optional buy-out, and who will be either obligated to purchase the shares or have the first, second and even a third option to buy the shares.

Also, a determination will need to be made as to the purchase price of the shares. Will the purchase price be set by the company, the shareholders, a formula, or an appraisal from a qualified valuation firm?

Business owners tend to "guesstimate" what their business can be sold for and believe they can extrapolate what the value of their shares would be based on that guesstimate. Accordingly, it is fairly common to see set valuations with periodic reviews or formula valuations with periodic reviews of the formula. Relying on a "guesstimate" or a formula can result in unintended consequences. For example, the shareholders may later realize that the guesstimated value is significantly less than or greater than the actual value of the company as determined by a business appraiser. It is also important to note that the value of shares for buy-sell purposes can be controversial because of the nature of the event. For example, in the event of the death of a shareholder, the buy-out price should be able to weather an examination by the IRS to determine that the price correctly reflects the true value of the shares. Issues such as minority discounts, premiums and marketability will often play into a determination of the value of the shares in such an event. Another example is valuation in the event of a divorce. While it is advisable to obtain the consent of a non-employee spouse to a buy-sell agreement, a divorcing non-employee spouse will often request and obtain a separate appraisal of his or her interest in the shares. For the foregoing reasons, more businesses than ever are relying on routine appraisals of the business to arrive at a buy-out price.

A buy-out of an equity interest of a corporation with a California employee also provides a rare situation in which it is possible to prevent a terminating employee from competing with the company. In California, generally, a covenant not to compete is unenforceable. One of the exceptions, however, is a covenant not to compete that is reasonable as to scope and term and is entered into in connection with the sale of shares. It is important to note that the buy-out price must contain some goodwill element for a covenant not to compete to be enforceable. As a result, a company cannot create an enforceable covenant not to compete simply by issuing an insignificant number of shares to an employee unless it can be shown that a portion of company goodwill was also included in the transaction.

The funding mechanism for the buy-out price is another crucial element of the buy-sell agreement. Life insurance is a typical funding mechanism in the event of the death of a shareholder. Disability insurance, while less common because of cost and availability, is favored for funding in the event of the disability of a shareholder. To the extent that such funding mechanisms exist, ordinarily, the buy-out would be mandatory.

However, a company or the remaining shareholders are unlikely to promise to fund a buy-out in an event that is funded by the income of the company. In such an event the buy-out is typically optional and is funded over a period of years.

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Dining Spotlight...

This new addition to Valorem Principia will feature different dining hotspots in various cities throughout California, providing highlights, reviews, and insights to our clients and friends across the state. If there is a place or event that you feel should be showcased in a future edition of this column, please contact Tracy Washburn at 310/571-3400, or twashburn@sphvalue.com.

What does an ambitious Frenchman, an incredible wine list, a vast array of succulent dishes, and the most popular aperitif in the south of France have in common? They are fundamental aspects to the success of Pastis, one of Los Angeles' most popular French Provencale restaurants.

Pastis is nestled among a row of trendy Los Angeles eateries in the heart of Hollywood on Beverly Boulevard at Crescent Heights. Its charming, street-front patio greets guests with a sense of French culture, whisking them away from the hustle and bustle of the outside world into the peace and serenity of an intimate countryside villa.

"Wow" may be the most commonly heard word at Pastis, as dish after dish arrives in waves of layered tastes and textures, vividly presented and harmoniously flavored with inspired combinations of superior ingredients. Appetizers resonate with freshness and creativity, as can be tasted with the melt-in-the-mouth ahi tuna tartar dusted with pine nuts and paired with a delicate cucumber salad, as well as with the circular confit and fresh tomato tart with thyme.

The obligatory foie gras attains a savory nod of approval, and the roasted rabbit filled with Chorizo rests on top of fava beans and black olives, and tends to disappear right off the plate just after the first bite.

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Main courses showcase more of the fabulous offerings of Pastis. A seared duck breast covered in scented honey with spices, black mission figs, and baby fingerling potatoes seems to call to the taste buds from afar, and the famous bouillabaisse, where seafood lays within a saffron broth with garlic croutons, leaves little to be desired…until the encore of the desserts is presented, that is.

Desserts are rich in artful presentations and intense tastes. House-made chocolate profiterolles are impressive, arriving amidst an ice cream and powdered sugar haven, offering a wonderful contrast between hot and cold, as the actual pastries are served fresh from the oven. Another fabulous dessert to try is the creamy rice pudding filled with plump raisins in every spoonful. There are also various fruit tarts and strudels available. If a sweet tooth desires something with a little more pizzazz, a glass or two of the succulent Muscat Mireval has been proven to settle the craving. Looking around the restaurant on an average night, one could expect to see a couple on an intimate date, a large group of people celebrating a birthday, a set of professionals conducting a business meeting, and a gathering of Europeans indulging on familiar French cuisine. Pastis is available for private parties, and can be rented out for any occasion up to 80 guests, and also caters events throughout the Los Angeles area.

Pastis - A Little Taste of Provence
8114 Beverly Boulevard (Crescent Heights Blvd.)
Los Angeles, California
323/655.8822

Hours:	Mon-Fri 12pm-2:30pm, 6pm-10:30pm; Sat-Sun 6pm-11pm
Cost:	Appetizers, $6-11; Entrees, $15-22; Vegetarian, $14; Sides, $4; Desserts, $6, Valet Parking (Thurs.-Sun only), $3.50

This little taste of Provence is the remarkable creation of Arnaud Palatan, a self-taught food connoisseur who has resided in Los Angeles for over twenty years.

Mr. Palatan is adamant about reinventing his 7-year-old restaurant quite often, with one-third of the menu changing every two weeks. The goal: to keep up with fickle attitudes and culture, and to renew the restaurant, but not deviate from what built the reputation Pastis has achieved thus far. He also stresses the importance of keeping current with every aspect of his privately owned business, from annual financial planning, consistent valuation of assets, and consumer analysis of trends in the Los Angeles food service industry.

Today, Pastis remains one of L.A.'s hidden treasures. Visit Pastis and experience a little taste of Provence, a votre sante!

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In reviewing the alternatives available in formulating a buy-sell arrangement, a director and shareholder must effectively wear "two hats". As a director, he or she will want to choose alternatives that are in the best interest of the company and will assure its continued success. As a shareholder, he or she will want to serve his or her own best interest. Oftentimes, the best interest of the company will prevail but not after some long and arduous discussions.

Because of the legal and tax consequences in determining the buy-sell arrangement, the company and shareholders often will seek the guidance of counsel in drafting a buy-sell agreement. The counsel could jointly represent the company and the shareholders, or just the company or just a shareholder. Similarly, in formulating an appropriate valuation, retaining an experienced and qualified appraiser is strongly encouraged.

Regina J. Schroder, Esq. is a shareholder in the Sacramento business law firm of Bartel Eng & Schroder. She is a former Chair of both the Sacramento County Bar Tax Section and the Taxation Section of the California State Bar. Regina received her J.D. from the University of California, Davis, School of Law, King Hall in 1982 and her Master of Laws in Taxation from the University of Pacific, McGeorge School of Law in 1984. She has extensive experience in assisting companies with their start up, financing and succession planning.

Success is to be measured not so much by the position that one has reached in life as the obstacles which he has overcome while trying to succeed
--Booker T. Washington

Published by SANLI PASTORE & HILL, INC.
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Articles, letters, comments and suggestions are welcome. Please contact *Tracy Washburn 310/571-3400 or twashburn@sphvalue.com*.

Layout designed by *Christine Le Albino*

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