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Good Business Practices in the Age of “E-Discovery”

By John Nielsen

It doesn't seem that long ago that businesses kept all their documents on paper, in file cabinets. When a company became involved in a lawsuit, it was fairly easy for litigants to obtain the documents they needed by simply copying the files, if they still existed. How times have changed! The growing importance of information technology in our work lives has brought with it new requirements for handling and preserving electronic data when that information may be needed in present or future litigation. This is especially true now that most new documents, including emails, power point presentations, multiple drafts of reports, etc., are never printed. These documents, including other data like voicemails are created and stored electronically. Also, there may be more information contained in your electronic documents than you realize. Many programs, such as Microsoft Word and Excel, include identifiers that are automatically saved and embedded in the file, including when and how long you worked on the document. This “metadata” can also include information such as previous drafts or versions of the document.

Therefore it has become very important for all of us to be aware of the legal implications of these technological changes. A growing body of law, as well as proposed legislation, dealing with the topic of discovery of electronic data, commonly known as “e-discovery”, is directed at how and when electronic documents should be preserved. The following is a very brief discussion of some of the issues involved.

1. Implement A Reasonable Records Retention Policy

First and foremost, your document retention policy must be “reasonable” taking into account the facts and circumstances surrounding the relevant documents. As an example, a three year records retention policy might be deemed sufficient for certain types of documents, such as appointment books or telephone messages, but inadequate for documents such as customer complaints. The decisions on whether to retain documents, and for how long, should be based on the content of the document, not the form. The retention policy should

handle documents in broad categories, and be objectively applied to all of the documents within that category. And once the document retention policy has been put in place, it should be communicated throughout the company and enforced. Importantly, your document retention program should not be used for the purpose of eliminating “bad” documents. When relevant evidence has been destroyed via the company’s document retention policy, in a lawsuit, the opposing party may allege spoliation of evidence, and a court could find that the retention policy was instituted in bad faith. A court will closely examine the timing and development of a party’s retention policy if it looks like that policy was created or implemented solely to gain an advantage in litigation. The policies you put in place should produce predictable results!

2. Document Your Retention Program

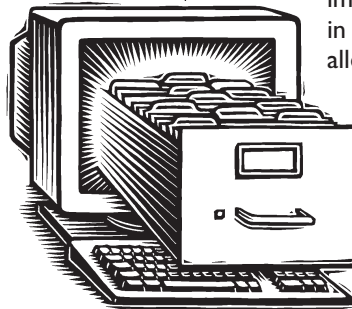
Also, you should document all of the steps in implementing your retention program in order to minimize potential allegations of bad faith. Make and keep copies of all notices relating to document preservation, documents showing when and to whom they were sent, as well as when and why persons that were subject to your retention policies were released from their retention obligations.

3. Be Careful With Backup Tapes!

Many companies back up their systems on a regular basis for disaster recovery purposes. If this is the case at your company, be mindful about holding onto backup tapes that are older than one or two rounds of backups. Some companies may keep backup tapes for many years, using them as quasi business archives. If this is the case, there may be other storage media options that would meet your needs, but eliminate some potential adverse consequences of keeping full backup tapes. If you are involved in litigation, the other side may be able to get those tapes and all of the information contained on them!

4. Be Ready To Implement A “Litigation Hold”

Regardless of what type of retention policy you put in place, if litigation is pending or threatened, normal practices must be suspended. As part of your document retention program, there must be a procedure to identify potential



Good Business Practices . . . Continued

(Continued from page 1)

disputes and protect the corresponding documents and electronically stored information. Once you reasonably anticipate that you will be involved in litigation, you have to institute a "litigation hold" to ensure the preservation of relevant documents. Also, the employees most likely to have the relevant documents should be notified in writing what needs to be preserved, including the subject areas and time

frames involved. The goal is to keep the relevant documents, so err on the side of being over inclusive. Lastly (and perhaps most importantly), if you feel that litigation is on the way, call your attorney immediately! Or better yet, talk to your attorney before there are any problems so you can get the policies and procedures in place that will protect you in the future. ☒

House Foundations – Understanding The Tax Consequences Of Real Estate Transactions

By Brendan Lund

"Bob and Mary recently sold their home for \$100,000 over their asking price – and it was only on the market for one week!"

"George and I recently bought and sold our interest in an undeveloped condominium complex and pocketed \$75,000 in profit."

"We just signed papers for a \$700,000 loan and the payments for the first three years are only \$1,800!"

Each of these statements can be overheard at cocktail parties, children's sporting events, or in the halls of a working environment.

Recent national and international publications have made the booming real estate market the subject of front page articles. Here in the Bay Area, the real estate market over the past five years has rapidly appreciated, reaching unprecedented levels. No one knows for sure where the local or national real estate market is headed, but a brief review of the tax consequences of real property ownership is helpful at this time of frenzied transactions.

Tax Considerations for Seller's of Real Property

The tax consequences to a seller of real property hinge primarily on the use of that property.

Primary Residence

Individuals selling property used as a personal residence for two of the previous five years can exclude up to \$250,000 of gain from capital gains tax. Married couples meeting the same requirements can exclude up to \$500,000 of gain from capital gains tax. California adopts federal law and allows residents meeting the federal rules to exclude capital gain on the California income tax return.

Gain is measured by the difference between the sales price and the income tax basis (i.e., what the individual paid for the property). To illustrate: thirty years ago Bob and Mary purchased a home on the Peninsula for approximately \$40,000. They are about to sell that same home for \$840,000. Because Bob and Mary have lived in that home continuously, they can shelter \$500,000 from capital gains tax. Their unrealized gain is \$800,000 (\$840,000 sales price less \$40,000 income tax basis). Because they meet the personal residence rules, Bob and Mary can exclude \$500,000 from capital gains

tax, resulting in recognized taxable gain of \$300,000. Bob and Mary will pay approximately \$72,900 in capital gains tax (\$45,000 based on federal capital gain rate of 15% and \$27,900 based on California 9.3% rate) on the transaction.

Income tax basis can be increased to reflect the cost of improvements made to the property. So, if Bob and Mary added on another bedroom, bathroom and family room fifteen years ago to accommodate their growing family at a cost of \$100,000, their income tax basis in the property would be \$140,000. This adjustment would reduce their recognized gain to \$200,000. It is always important to maintain records of the cost of improvements made to real property.

Investment Property

The benefit of the personal residence exemption is not available to individuals or couples owning investment property, such as rentals or vacation homes. Thus, when a person sells investment property, the capital gain is measured by the difference between the sales price and the income tax basis. There is no exclusion of gain available for this type of property.

The applicable capital gain rate for investment property depends on how long the property has been owned. Real property owned for one year or longer is taxed at 15% capital gain rates. Property held for less than one year is taxed at ordinary income rates. Thus, if a taxpayer is in the 33% income tax bracket, the sale of investment property held for less than one year is taxed at 33% rates. California taxes all property at 9.3% rates, regardless of length of ownership.

Many taxpayers depreciate their investment property annually to receive an extra tax deduction. Depreciation reduces the income tax basis of the property, resulting in higher gain when the property is sold. Unfortunately, some taxpayers are not aware of the depreciation recapture laws which tax a portion of the gain at higher tax rates.

To illustrate, Joe and Sue own a rental condominium in Oakland that they purchased five years ago for \$500,000. The condo has been rented continuously since it was acquired and the owners have depreciated \$50,000 of the original purchase price. Joe and Sue now have sold the condo for \$700,000, and due to depreciation, have an adjusted income tax basis of \$450,000. The depreciation recapture rules require Joe and



House Foundations . . . Continued

Sue to recognize tax on the \$50,000 depreciation at ordinary income rates. The balance of the gain, here \$200,000, is taxed at 15% capital gain rates.

Tax Considerations for Buyer's of Real Property

There are less immediate tax advantages to a buyer of real property, since the buyer is just commencing the transaction. However, buyers of real property can deduct on their income tax return a number of costs associated with property ownership.

Costs, fees and taxes imposed during escrow can typically be deducted by the buyer of real property on the tax return for the year in which the purchase occurred. Likewise, a property owner can deduct county property tax payments made during the taxable year.

Mortgage interest paid during a tax year also generates a large tax deduction. The lender must issue a Form 1099 at the end of each calendar year documenting the amount of mortgage interest paid to the lender during that period. Because of this ability to deduct mortgage interest, many first-time buyers receive a large tax refund following their first full year of home ownership. Adjustments can be made to monthly salary withholding to account for these large deductions. Proper adjustments minimize federal tax withholding, increase monthly take home pay and reduce the refund received at tax time. Basically, putting more money in the taxpayer's hands on a monthly basis.

The ability to deduct all mortgage interest is not absolute. Under federal law, indebtedness is classified as acquisition debt and home equity debt. Acquisition debt is indebtedness incurred to acquire, construct or substantially improve a residence. Home equity debt is all other indebtedness that is secured by a residence. The deductibility of interest paid is determined by these categories. The aggregate amount of acquisition debt may not exceed \$1,000,000 and the aggregate amount of home equity debt may not exceed \$100,000. Interest attributable to debt over these amounts is nondeductible personal interest.

These limitations can be relevant at a time when individuals are purchasing million dollar homes with minimal down payments or when homeowners are extracting large sums of equity for personal use. In these specific situations, interest paid may not be deductible.

Tax Consequences of Mortgage Debt

Many commentators have noted riskier behavior among lenders, home buyers and investors. Regardless of whether

individuals or couples are planning to buy, sell or invest, it is important to understand the nature of loans and the tax consequences stemming from the debt.

Generally, debt secured by property is classified as recourse on nonrecourse debt depending on the lender's ability to recover the full liability. Recourse debt means that the borrower is personally liable for the full amount of indebtedness. Nonrecourse liability limits the lender's recovery of debt to no more than the fair market value of the property securing the indebtedness.

To illustrate: Steve purchases a home for \$700,000 and assumes a \$650,000 mortgage. A year into his mortgage

Steve loses his job and has fallen behind on his mortgage. Making matters worse, his home has decreased in value to \$600,000. The bank initiates foreclosure proceedings and sells the home at an auction for \$500,000. If the mortgage is considered recourse debt, the lender can hold Steve personally liable for the \$150,000 still outstanding on the mortgage after the sale of his home. However, if the mortgage is considered nonrecourse debt, Steve is not obligated to pay the additional \$150,000 of the loan and the bank takes a loss on the whole transaction.



In California, most first mortgages are classified as nonrecourse debt. However, many second mortgages and home equity loans are classified as recourse debt, subjecting the borrower to personal liability in the event of default. Borrowers should carefully examine their loan documents to understand their obligations.

The illustration above contemplates a scenario involving foreclosure proceedings. Certainly a foreclosure can devastate a homeowner's credit, but it also has negative tax implications. Oftentimes, foreclosure proceedings result in cancellation of debt. Federal tax laws require cancellation of debts to be deemed income to the taxpayer. This can result in a large tax liability in the same year that a foreclosure occurred.

Conclusion

Just as the tax tail should never wag the dog in a business transaction, the same remains true when buying or selling real property. Certainly, tax planning may be a deciding factor when contemplating a purchase or sale. However, it should never be the sole factor.

In these frenzied times, it is important to remain mindful of some basic tax consequences. An educated and informed decision helps alleviate much of the stress surrounding significant investment decisions. ❖

Attorney General Clamping Down On Corporate Scams By Nancy Hargiss

Many of our corporate clients have contacted us about notices that they have received in the mail or by fax concerning "corporate compliance" and the fees that the corporation is "required" to pay. These very official-looking notices are nothing more than scams preying on California

corporations. The Attorney General of California is now clamping down on the scammers. The following information comes directly from the California Franchise Tax Board website at <http://www.ftb.ca.gov>:

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Attorney General Clamping Down cont ...

(Continued from page 3)

Mail Scheme Targets California Corporations

The Attorney General's office is looking into a mail scheme aimed at California corporations. The way the scheme works is that corporations receive mailers implying that they must fill out a form and pay a specified fee (usually \$125) to remain in compliance with California law. The mailers give the impression that they are sent by a government agency and that the fee is mandatory. These scams are operated under official-sounding names like Corporate Compliance Center, Board of Minutes and Resolutions, and California Corporate Compliance. The U.S. Postal Inspector is also looking into these deceptive mailers.

If your office receives any complaints regarding this type of solicitation, please forward the complaint to the Attorney General's Office at the Department of Justice, at the address below, or advise the complainant to contact the Attorney General's office. The complainant should send the original mailer as well as the envelope in which the solicitation was mailed.

Complaints may be filed with the Department of Justice by mail, telephone, fax, via the Internet, or by email:

MAILING ADDRESS:

Attorney General's Office
California Department of Justice
Attn: Susie Lorden
110 West A Street, Suite 1100
San Diego, CA 92101

TELEPHONE: 1-800-952-5225 (Toll-free in CA)
or (916) 322-3360

FAX: (916) 323-5341

WEBSITE: <http://ag.ca.gov/consumers>

EMAIL: <mailto:piu@doj.ca.gov>



Any time you receive a notice in the mail that looks suspicious, please feel free to contact one of our attorneys and ask him or her to review the notice to determine how it should be properly handled. ☒

Clients on the Go! The Children's Internet, Inc. By Patrick Guevara and Kevin Martin

McNichols Randick O'Dea & Tooliatos is proud of its client The Children's Internet, Inc. ("TCI") as it makes strides in the children's personal computing market.

On August 30, 2005, TCI announced that it signed a contract with a top ranked media buying company, Mercury Media of Santa Monica, California, to exclusively manage the distribution of television infomercials promoting its flagship product The Children's Internet®.

"I believe a successful infomercial campaign will set the stage for showcasing The Children's Internet® and become the foundation for all of our other marketing and advertising initiatives," said Sholeh Hamedani, CEO of TCI. The company plans to roll out The Children's Internet® infomercial in 2006.

TCI is the exclusive licensee, marketer and distributor of The Children's Internet®. Ranked by PC Magazine® as "Editor's Choice" and number one in the category of "Kid's Browsers and Services", The Children's Internet® service is the most comprehensive and secure Internet portal specifically designed for children from pre-school to junior-high. The Children's Internet® portal offers a rich array of applications such as

World Wide Web access, secure e-mail, Internet search engine, homework help, games, news, and other learning activities all within a child-safe, protected online community. The portal is protected by the proprietary, patent-pending SafeZone Technology® software that secures the child's entire computer from online dangers such as online predators and crude, inappropriate content.

In other recent news, TCI announced on October 20, 2005 its formation of a "Users Advisory Group" to assist in brainstorming both technical and content-related issues as The Children's Internet® service is launched later this year. "This will make our pre-launch more effective," said Ms. Hamedani. "The group will serve the traditional user-group role of providing a means of communicating user issues, but we also expect this group to exceed their traditional role by identifying new marketing opportunities for the company."

TCI's stock is publicly traded in NASDAQ's OTC Bulletin Board under the symbol CITC. TCI's website is located at <http://www.thechildrensinternet.com> ☒



GOING PLACES – A Japanese Adventure By Steve McNichols

This summer, my wife, Kathy, and I had a wonderful opportunity to see the island nation of Japan in a unique way. We went with a group of 20 eclectic people that had one thing in common - Judy Chiu. Judy teaches Chinese and Chinese brush painting. The group, except for my wife and I, were her adult students. Judy, her husband and several other people in the group spoke fluent Japanese.

The primary feature that made the trip different from the traditional trip to Japan was that we stayed almost exclusively

at Japanese hot spring inns (ryokans) in the country's highest and wildest mountains. There were few, if any, non Japanese at these traditional inns. The inns were located in areas that are remote enough to have kept much of the traditional rural lifestyles, architecture and festivals. We experienced an authentic Japanese vacation.

We traveled in the central region of Japan's largest island, Honshu. This area stretches between Tokyo and Kyoto, the Pacific Ocean and the Sea of Japan. Its terrain ranges from

GOING PLACES – A Japanese Adventure cont ...

rugged seascapes in the north, the spectacular mountain ranges and highlands of the Japanese Alps in the center, and the urban, densely populated Pacific coast on the south. The dramatic contrasts between the modern urban centers and the underpopulated rural areas is stunning – futuristic architecture and traditional temples and shrines; robed zen monks, kimono-clad geisha and black suit, white shirt and tie clad businessmen; quaint thatch-roofed villages and pulsating neon urban jungles.

The Japanese countryside is absolutely beautiful! Contrary to our expectations, outside of the major cities, there is very little traffic and the population is sparse. The people live in small, picturesque villages – very much like Switzerland. The terrain is mountainous and rugged with dense vegetation and beautiful rushing streams. Virtually every house has a small, traditional Japanese garden.

Once we were welcomed to the inn, usually by the entire staff in a reception line, we would enter our elegantly simple room with tatami (reed mat) floors, a view of the mountains or streams and a simple alcove with a single, elegant flower. We would don comfortable, Japanese robes (yukata) and sandals, drink tea or sake, enjoy the hot springs, Japanese baths (separate for men and women), have a massage, take walks in the gardens or woods, and just completely relax! We slept on thick futons laid out after dinner.

The Japanese people are extremely polite and gracious – the Tokyo subway excepted. The food is delicious, fresh and diverse. In the country, at least, the Japanese do not waste a single thing. They find delicious ways to serve sea weed, roots and leaves.

The artistic presentation of the food enhances the enjoyment of the cuisine. Each restaurant has its own specialty and the service is impeccable. Tipping is not part of their culture, and gratuities will usually be rejected if offered. In Japan, superb service is expected, and the staff takes personal pride in their work.

The entire country is the cleanest place I have ever seen – no trash, litter or graffiti. Cars must be inspected each year and will not be licensed if they have an unrepaired dent. The cabs and busses are immaculate and the drivers wear gloves and suits and ties. Streets are safe, families are close knit and take care of their young and old. We saw little police activity, violence or homelessness.

Japanese art, architecture, pottery and fabrics are some of the most creative and beautiful in the world. Japanese seem to thrive on simplicity in the country and are mega consumers of gadgets and clothes in the cities. We visited a number of Zen temples and monasteries. The simple, introspective lives of the monks, and the country people in general, contrasts sharply with the frenetic hustle of Japanese urban life.

Japan is a country of great physical beauty, gracious people, spectacular, ultramodern urban buildings, and a bustling urban community living in a neon lit, hyper consumer environment. This contrasts with mist shrouded mountains, tranquil, traditional Zen and Shinto temples and monastic communities, farmers working their rice paddies with traditional tools, beautifully simple gardens, historic castles and creative art. We loved this country, and I think anyone with a sense of adventure and curiosity would enjoy visiting this enigmatic country and culture. 🍷



Epicurean Delights

Swedish Glögg (Hot-Mulled Wine)

by Brendan Lund

The holidays bring with them a number of festive occasions or opportunities for family and friends to drop by your home. Here is an easy recipe for holiday cheer and one that makes the home smell fantastic!

1.5 liter bottle of inexpensive dry red wine

1.5 liter bottle of American port

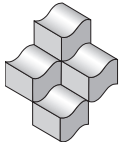
2 packages frozen raspberries

4-5 cinnamon sticks

**1 bottle brandy or aquavit
sugar**

Defrost the frozen raspberries. In a large pot mix the red wine and port and place over low heat. In a separate pot, add the raspberries and sugar and cook down the raspberries over medium heat. If the raspberries do not liquefy in the pot, then blend in a blender until sauce-like. Strain the raspberries into the pot of wine and port so that no seeds are added to the wine. Add to the glögg the cinnamon sticks and brandy or aquavit to taste. Continue to heat over low heat for 45-60 minutes. Excess glögg can be poured back into the wine and port bottles and stored and reheated.





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Achieving Results Through Innovation®

Quips & Quotes By John Nielsen

"I have not yet begun to procrastinate."

—**unknown**

When a man's best friend is his dog, that dog has a problem.

—**Edward Abbey**

There is a theory which states that if ever anybody discovers exactly what the Universe is for and why it is here, it will instantly disappear and be replaced by something even more bizarre and inexplicable. There is another theory which states that this has already happened.

—**Douglas Adams**

A positive attitude may not solve all your problems, but it will annoy enough people to make it worth the effort.

—**Herm Albright, author (1876-1944)**

We are what we repeatedly do. Excellence, then, is not an act but habit.

—**Aristotle**

We are here on earth to do good for others. What the others are here for, I don't know.

—**W. H. Auden**

The best way to get most husbands to do something is to suggest that perhaps they're too old to do it.

—**Ann Bancroft**

As every cat owner knows, nobody owns a cat.

—**Ellen Perry Berkeley**

I don't know what's wrong with my television set. I was getting C-Span and the Home Shopping Network on the same station. I actually bought a congressman.

—**Bruce Baum**

Dogs have more friends than people because they wag their tails instead of their tongues.

—**Martha J. Beckman**

I have a great diet. You are allowed to eat anything you want. But you must eat it with naked fat people.

—**Ed Bluestone**

We have women in the military, but they don't put us in the front lines. They don't know if we can fight, if we can kill. I think we can. All the general has to do is walk over to the women and say, "You see the enemy over there? They say you look fat in those uniforms."

—**Elayne Boosler**

I am not a vegetarian because I love animals. I am a vegetarian because I hate plants.

—**A. Whitney Brown**

The secret of a good sermon is to have a good beginning and a good ending and have the two as close together as possible. Too bad that all the people who know how to run this country are busy driving taxis and cutting hair.

—**George Burns**

