

HELLER, EHRMAN, WHITE & McAULIFFE

ATTORNEYS

THIRTIETH FLOOR • WELLS FARGO BUILDING

44 MONTGOMERY STREET • SAN FRANCISCO, CALIFORNIA 94104

TELEPHONE: AREA 415 981-5000

September 17, 1976

Mr. and Mrs. Henri Takahashi
7 Shore View Avenue
San Francisco, California

Dear Mr. and Mrs. Takahashi:

Enclosed is a memorandum summarizing a proposed tax strategy for Takahashi, Inc. and both of you as individuals. I had delayed sending this memorandum in the hope that the 1976 tax legislation would be formalized, so that I could incorporate its provisions into the strategy. Although the Congress now has sent a bill to the White House, there may be some delay before the President decides whether to sign or veto the present bill. Since it is imperative for you to make some tax decisions in the next several months, I decided to send the memorandum out in its present form, subject to revision when the final tax legislation becomes known. In doing so, I must emphasize that the impact of the new tax legislation on your tax situation could be substantial.

In reviewing this memorandum, please consider the following:

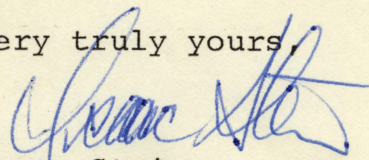
1. We have done substantial research in each of the areas described in the enclosed memorandum. However, I concluded that rather than give you dozens of pages of technical memoranda, it instead would be preferable to prepare a brief summary of the basic decision areas. Once we have discussed the basic issues, I would expect that we would prepare more detailed memoranda with calculations of the specific tax consequences.
2. Most of the proposed actions require fundamental non-legal decisions. For example, the recapitalization of Takahashi, Inc. would require a decision as to your testamentary intentions for the business. Any action that you take will require a balance of values,

a weighing of advantages or disadvantages. I should like to emphasize, as you undoubtedly are already aware, that inaction is a course of action.

In accordance with our conversation this afternoon, I am sending copies of the memorandum to Mrs. Suzuki and Jeff Howson at Arthur Young & Company. Please call me after you have had an opportunity to review the enclosed so that we can arrange a meeting.

Best regards.

Very truly yours,



Isaac Stein

for HELLER, EHRMAN, WHITE & MCAULIFFE

enclosures

cc: Mrs. M. Suzuki

Mr. Jeff Howson

M E M O R A N D U M

Introduction

Mr. and Mrs. Henri Takahashi are 80 percent shareholders of Takahashi, Inc. (the "Company").^{1/} The remaining 20 percent of the Company's shares is now held by Mrs. Takahashi's sister and her husband, the Suzukis, and a number of other employees of the Company.^{2/}

For more than 20 years, the Company has been engaged in the importing of Japanese giftware. Most of this giftware is sold to major stores around the country. Some of the imports are also sold at retail by an affiliated corporation, Takahashi Imports, Inc., which is owned 100 percent by Mr. and Mrs. Takahashi.^{3/}

^{1/} The business of the Company was formerly conducted through two brother-sister corporations which merged in December 1975 and adopted the name Takahashi, Inc. All references to the Company in this memorandum refer to the total business enterprise.

^{2/} In addition to their stock ownership, the Takahashis also own the real property and some of the improvements located on the property which comprises the main office and warehouse of the Company ("Fifteenth Street Property"). Under a "printed form" lease entered into in March 1966, the Takahashis have leased this property to the Company at \$30,000 per year for a term expiring in March 1986. It is our understanding that this lease rate is substantially lower than the fair market rental value of the property.

^{3/} Although the retail stores are better known to the public, they are not a material portion of the total business of the Takahashis and, at the present time, do not present serious tax problems.

Although the operations of the Company have always been profitable, since 1970 there has been a dramatic escalation in profits which, in turn, has created significant tax problems, both for the Company and the Takahashis.^{4/} The principal tax problems of the Company are the possible imposition of an accumulated earnings penalty tax on the retained earnings of the Company and the possible disallowance of deduction on some portion of the compensation paid by the Company to the Takahashis and Suzukis pursuant to employment contracts. The principal tax problems of the Takahashis, as individuals, are their substantial ordinary incomes and their substantial estate tax liabilities. As a practical matter, the tax problems of the Company and the Takahashis are inter-related and must be considered within their combined economic framework.

The purpose of this memorandum is to summarize an integrated tax strategy for the Company and the Takahashis. The principal objectives of this strategy are:

1. To minimize the risk of either penalty taxes on accumulated earnings or disallowed compensation deductions;
2. To maximize the ability of the Takahashis to receive cash from the Company at the lowest combined tax cost to the Company and the Takahashis;

^{4/} For example, between 1970 and 1975, the Company's after-tax profits increased from \$337,000 to \$1,073,000.

3. To minimize the estate and/or gift taxes payable in connection with the transfer of assets from the Takahashis to their children.

Conclusions

We recommend that the following actions be taken:

1. Employment Contracts

The Takahashis and Suzukis should enter into new employment contracts (retroactive to January 1, 1976) for a term of not less than 5 years. These contracts would contain a salary plus contingent bonus provision as do the existing contracts. However, the contingent bonus provision will have:

- (i) a maximum limit equal to the 1975 payment;
- (ii) a declining scale for bonus payments as profits increase; and
- (iii) an expected payment equal to not more than approximately \$175,000 for Mr. Takahashi, with proportionately less for the others.

The recitals in the contract should emphasize the inadequacy of past compensation, especially during the early years of the Company. As between the various corporations and individuals, some attempt should be made to relate

compensation to the responsibilities of the individual. For example, since Mrs. Takahashi spends a substantial portion of her time on the retail stores, a substantial portion of her compensation should come from Takahashi Imports, Inc. On balance, we believe that the contracts should not continue to contain an agreement to repay the compensation in the event of a disallowance of the deduction for the payment by the Company. Finally, we believe that the Company should consider the adoption of a fixed benefit pension plan. Such a plan could be weighted in favor of the principal executives and the funding requirements for the benefits could ameliorate further the risk of an accumulated earnings penalty tax.

2. Recapitalization

We believe that substantial tax benefits could result from a recapitalization of the Company. In a recapitalization, the Takahashis would exchange most of their existing common stock holdings for a preferred stock equal in value to the present value of the equivalent proportion of the Company's equity. This new preferred stock would have voting rights so that the Takahashis would continue to have control of the Company. Although the mechanics of a recapitalization can be complex, the

basic concept is to "freeze" the present value of the Takahashis' interest in the Company and permit future increases in the value of the Company to be excluded from their estate. By making gifts of their remaining common stock to their children at the time of the recapitalization, the Takahashis could minimize the taxation involved in transferring their estate. Since the Takahashis are in a high estate tax bracket (because of assets other than the Company), the marginal estate tax savings can be very substantial. In addition, common stock could be sold at nominal prices to key employees as an incentive to produce future earnings. Such a sale to employees could also include a "vesting" based on continued employment.

3. Fifteenth Street Property

We believe that the Takahashis should consider either (i) a gift of the Fifteenth Street Property to their children followed by a sale of the Property to the Company or (ii) a gift of some of their shares in Takahashi, Inc. to their children followed by a sale of the Property by the Takahashis to the Company on a capital gains basis. This sale could be for either cash or a combination of cash and notes. The purchase price would have to be determined

by appraisal and this appraisal would be complicated by the existing lease. The result of the sale would be to reduce the accumulated earnings problems of the Company and possibly to permit the sale of the Property by the children in a lower tax bracket. Depending upon the desires of the Takahashis, gifts could be made either outright or through trusts which would regulate the amount of cash made available to their children.

TAKAHASHI (A CORPORATION)

Book value as of June 30, 1975

Total number of shares: 465 shares

Shareholders:

Henri and Tomoye Takahashi
Masako Suzuki

FAR EAST TRADE COUNCIL (A CORPORATION)
dba COUNTERPOINT

Book value as of June 30, 1975

Total number of shares: 1795 shares,

Shareholders:

H. and T. Takahashi
Masako Suzuki
Risaburo Suzuki
Norman Takahashi
Frank Iyama
Joe Kakiki
Alan Reece

JACK MORRIS

IF NOT DELIVERED IN 5 DAYS RETURN TO
HELLER, EHRMAN, WHITE & McAULIFFE
ATTORNEYS AT LAW
THIRTIETH FLOOR
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SAN FRANCISCO, CALIFORNIA 94104



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