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## **2007 YEAR END UPDATE:** **HOSPITALITY LEGAL ISSUES**

This has been an exciting year at the Miller Law Group (MLG) because we have created innovative strategies which have made a substantial difference for our clients. The purpose of this Update is to report on certain recent matters, which may be relevant and useful.

The following legal areas are highlighted: **Organizational Structuring and Tenancy In Common Issues, Real Estate Exchanges Under IRC §1031, Franchise Agreements, Franchise Negotiations, Employment Issues, and a Wealth Strategy Tax Tip.**

### **ORGANIZATIONAL STRUCTURING AND TENANCIES IN COMMON**

**Case 1:** A client purchasing two lodging properties sought to structure each acquisition to be eligible for tax-free exchange treatment under IRC §1031. Each property contemplated co-investors, also needing §1031 treatment, and one purchaser who would be acquiring the property pursuant to a reverse §1031 exchange. Further, two purchasers each investing in both properties wished to reallocate their ownership interests in the properties based on their membership in the limited partnerships formed to be the purchasing entities. Through the creative application of tax law, tenancy-in-common agreements, and limited partnership minority interest valuation adjustments, MLG engineered all transactions to synchronize and achieve the economic goals of all parties.

**Case 2:** Some members of a limited liability company anticipating a sale of their hotel wished to invoke §1031 tax deferral treatment. Other members did not. We positioned the members for effecting §1031 treatment by distributing the asset in fractional shares, continuing hotel ownership pursuant to a tenants in common agreement and a management agreement with the preexisting ownership entity. This avoided the preexisting entity from having to purchase the replacement property. Note: the proper drafting of the management agreement and possible amendments to the preexisting LLC operating agreement are key to avoiding tax recognition on the distribution of the fractional shares.

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## REAL ESTATE EXCHANGES UNDER IRC §1031

**Avoid Taxable Boot** through the nonrefundable transfer of cash before the close. This problem can arise even if the seller does not receive the cash but is deemed to have received it. When entering into a §1031 exchange, make sure that all cash, regardless of source, is to be retained by the escrow agent for use exclusively for the purchase of the exchange property and not to be released to the seller. In one situation, we identified \$1,000,000 in potentially taxable boot. We created a modified closing procedure, saving the client approximately \$250,000 in tax.

**Remember, if the money has not yet changed hands, it's not too late to set up a §1031 exchange.** For a new client who was days from a scheduled closing, we set up a deferred exchange. Even after locating the replacement property, the client would have realized significant taxable boot. We helped the client locate a second replacement property on the 44<sup>th</sup> day after closing, thereby allowing him to defer all the taxable gain. The cost to set up the deferred exchange prior to the closing can be the best investment a seller can make if there is any chance of reinvesting sale proceeds.

**Consider allocation of the sale price and purchase price of the two properties to the personal property at each location.** At times, the benefits of non-recognition of gain on the sale of personal property may be offset by taking higher future depreciation deductions on the acquired personal property. What's important is careful analysis of the potential tax treatment and effective negotiation of the purchase and sales contracts in order to optimize allocations between real and personal property. While tax benefits will never turn a failing investment into a success, using them wisely can change a good investment into a home run.

## Franchise Agreements

When negotiating franchise agreements, we have obtained significant accommodations. Typically, as many as 35 to 40 provisions in a franchise agreement are unsatisfactory. Attempting to negotiate all of these, usually results in no changes. However, knowing the limitations of the franchisor and presenting 6 to 12 reasonable requests will often yield desired results. Note, a prospective franchisee needs to discuss with counsel all 35 to 40 items, many of which impose legal obligations or risk that a prudent business person should understand.

Each franchisor has inviolate terms and also issues on which it will compromise. Some of the areas in which we have achieved accommodations include: liquidated damages, time limited maximums regarding upgrades, indemnification, area of protection definitions, realistic time schedules and extension fee waivers for new builds, right of first offer or a right of first refusal to buy the property in the event the franchisee wanted to sell, impact of impossibility of performance

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during development, and entity transfer provisions to accommodate business realities. Addressing these issues during the negotiation before signing the agreement is always best, but can also be worked through to a reasonable resolution, short of a lawsuit.

## Franchise Litigation

Aggressively advocating for a franchisee, MLG successfully challenged a well established maxim that has allowed franchisors to hide behind the Uniform Franchise Offering Circular (UFOC). UFOC's have operated as a shield and franchisors have maintained that if they comply with required disclosures then they are not accountable for information they do not disclose. The California Court agreed with MLG's position, that the UFOC imposes minimum requirements and that a prospective franchisee should receive all information material to making an informed decision about entering into the agreement.

Another important issue involves the implied covenant of good faith and fair dealing. Typically, Courts will not sanction this cause of action unless it references an express obligation in the agreement. In this case, the Complaint alleges nonperformance by the franchisor, despite no specific provision requiring performance by the franchisor. Since the allegation goes to the heart of the agreement, establishing brand identification, the Court ruled that the action was properly stated.

It must be noted that these issues will have to be proven at trial but they stand for the principle that a franchisee can seek redress when a franchisor misleads a franchisee, and that a franchisor's complete failure to perform can be a triable issue.

## EMPLOYMENT ISSUES

**Employee Related Practices Insurance** - What is a greater likelihood, your business burning or a disgruntled employee making a wrongful termination, harassment or other such employee practices related claim? Do you have fire insurance? Do you have employment related practices coverage? The answer to the former is almost always yes, while the answer to the latter is often no. Statistically, employment claims are usually defensible but the legal cost is enormous. The standard employment related practices endorsement includes the cost of defense. Be smart! Insure yourself to avoid the burden of costly legal defense.

**Maintaining up to date employee manuals** with certain language will protect you from many employee claims regarding policies and procedures of your company. A good example of this involves email policies and an employee's reasonable expectation with respect to the right of privacy. Check with your payroll companies; often they will provide this documentation at little or no extra charge, minimizing related legal expenses. Of course, we encourage legal review of such manuals as a safeguard, but at least take the minimal step.

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**California Overtime Issues** – Employers should not count on minimizing overtime claims under the new rules, particularly in a termination (disgruntled employee) situation by (1) documenting job descriptions including focus and time requirements (at least 50%) on supervisory assignments versus line responsibilities and (2) implementing regular performance reviews consistent with those expectations. In one case decided by a judge at trial, the Court ruled that when a general manager performs many line duties (usually in smaller properties), even if those tasks are many times filling personnel shortages, the aggregate can result in the employer be obligated to pay overtime to the general manager. The best way to avoid such claims is to compute general manager compensation with the idea the overtime is likely and if accounted for in the salary negotiation, the economic impact can be avoided.

## WEALTH STRATEGY TAX TIP

**The “Kiddie Tax” loophole is set to tighten on 1/1/2008.** For years, a popular tax saving strategy for high-income taxpayers with children over 14 (changed to 18 in 2006), was for parents to transfer some or all of income-producing assets into the child’s name, thus shifting income from a high tax bracket into the child’s typically low tax bracket. Often the tax saving was applied to higher education. Effective 1/1/2008, Congress raised the age to 19, and if the child is still a dependent full-time student, the applicable age increases to 24. By age 24 it usually too late to harvest any tax savings to help pay for college.

**ALERT:** There is still a window for certain taxpayers to benefit from the current rules until 12/31/2007. Under current law, children aged 19 to 23, whose tax rates for unearned income or capital gains will be raised to their parents’ rates as of January 1, 2008, remain exempt from the kiddie tax.

The difference in tax rates can be substantial. The lowest capital gains rate for most taxpayers is 15%, but for most children and young adults the rate is 5%. For those who have previously gifted highly appreciated assets to children, selling before year end may effect substantial tax savings. A long-term capital gain of \$50,000 for your 18 year old college-bound daughter may incur an additional \$5,000 in tax on 1/1/2008. Alternatively, another option is simply to be patient. When the child graduates from college and is no longer a dependent, the child could sell the asset subject to tax at their own marginal tax rates. This could be used to pay back student loans. MLG’s planning professionals can help hotel and business owners understand these types of issues, weigh their options and devise strategies to meet their financial and personal goals.

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## **ABOUT THE MILLER LAW GROUP, A PREMIER HOSPITALITY AND REAL ESTATE LAW FIRM**

We are a team of hospitality and real estate legal professionals, providing comprehensive representation in the areas of purchase and sale, transactional structuring, joint ventures, finance, tax, franchising, litigation, and wealth planning. By working together as a team, we provide comprehensive legal and strategic business counsel directed to the needs of hotel owners, developers and management companies. The team is directed by Mitch Miller, whose 25 years of experience includes representing hotel owners, developers and management companies, as well as serving as Chief Operating Officer for two hotel companies.

## **MILLER LAW GROUP UPCOMING EVENTS**

November 6-7, 2007 - California Lodging Expo, Marriott City Conference Center, Oakland, California, sponsored by the California Lodging Industry Association and the Asian American Hotel Owners Association.

- ◆ November 6<sup>th</sup> at 2:00, Mr. Miller will be speaking on Franchise Developments.
- ◆ November 7<sup>th</sup>, from 12:00-5:00, the MLG team will be available to answer questions at Booth 212

January 23-24, 2008 – Hotel Brokers International Marketplace, Las Vegas, Nevada. Mr. Miller will be speaking on the Purchase and Sale of Hotels – Legal Issues.

## **CONTACT INFORMATION**

For questions, comments, or further information contact Mitch Miller, at [mmiller@MillerLG.com](mailto:mmiller@MillerLG.com) or 650-566-2290.

**The foregoing information is in no way intended as an exhaustive description of all of the pertinent laws and regulations but merely highlights some of the important rules applicable to certain highlighted issues. The recipient is advised to engage counsel when engaging in any of these matters. This newsletter is distributed with the understanding that the Miller Law Group is not rendering legal, tax, or other advice or opinions on specific**

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