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The Rodi Review

Fall 2004

Letter from the Editor

Welcome to the "new" Rodi Review, *which we have expanded from being a Trusts & Estates newsletter to a full firm publication. We plan to provide you with articles of interest from all of our practice areas.*

In this issue, Tom Curtiss discusses new legislation affecting California registered domestic partners. In addition, Patrick Cain discusses California's controversial "Sue Your Boss" law, which allows employees to collect money for reporting even minor violations of certain state Labor Code laws. Finally, Hank Pramov writes about tax-advantaged exchanges of real property.

We hope you all have a happy and healthy holiday season!

Jean Beasley

In This Issue

Legal Alert! page 1

IRS Section 1031 — Tax-Free Exchanges of Real Property page 1

California Levels the Playing Field for Employers in Employee Disputes — Somewhat page 2

A Peek Through the Transom at Rodi Pollock page 4

Legal Alert!

by Thomas Curtiss, Jr.

To All Formally Registered Domestic Partners:

On January 1, 2005, extensive changes to the California Domestic Partnership Law will go into effect. The general goal of the changes is to confer upon registered California Domestic Partners the same rights, responsibilities and duties now conferred upon conventional spouses under California law.

CONTINUES ON PAGE 3

IRS Section 1031 — Tax-Free Exchanges of Real Property

by Hank Pramov

Conventional wisdom holds that it is almost always better to pay taxes later rather than sooner; however, fewer and fewer tax deferral methods remain viable. Internal Revenue Code Section 1031 offers perhaps the most advantageous tax deferral method still available today.

Section 1031 allows a taxpayer to defer gain on certain sales or exchanges of investment real property. This deferral option is especially attractive in California where property values are at an all-time high. Under Section 1031, a taxpayer can exchange qualifying real property for other qualifying real property and realize *no* gain on the exchange portion of the transaction.

As a result, the taxpayer will be able to retain for reinvestment a significantly greater portion of the sale proceeds. For example, if a property owner should sell investment property for $1,000,000 and have to pay $200,000 in taxes on the sale, the property owner would only have $800,000 for reinvestment. If the property owner instead structures properly a Section 1031 exchange, he or she could avoid any current tax liability and be able to reinvest the entire $1,000,000 in like kind property.

> *Under Section 1031, a taxpayer can exchange qualifying real property for other qualifying real property and realize* no *gain on the exchange portion of the transaction.*

CONTINUES ON PAGE 4

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California Levels the Playing Field for Employers in Employee Disputes — Somewhat

by Patrick J. Cain

By enacting laws and regulations that are perceived as excessively 'anti-business,' California has earned what is in many respects a well-deserved reputation as a hostile economic and regulatory environment for businesses operating in the state. One recent example is the Labor Code Private Attorneys General Act of 2004, nicknamed the "Sue-Your-Boss Law" or "Bounty Hunter Law."

The Labor Code Private Attorneys General Act of 2004

This statute is a controversial legacy of the Gray Davis administration, originally to be effective January 1, 2004, and applicable to *all* employers in the state. The Act gave employees the right to sue their employers and collect money penalties for even the most minor violations of specified California Labor Code sections, as to which previously only the appropriate state agency could assess and collect penalties. In addition, the Act allowed a prevailing employee's lawyer to collect attorneys' fees, while denying the same right to a prevailing employer.

By mid-year, the Act had earned its nicknames. By at least one estimate it had resulted in more than five dozen new lawsuits, seeking recoveries totaling half a billion (yes, billion) dollars. This included at least one lawsuit in which the alleged violation was that posted notices on the employer's bulletin board were not in the type size required by the applicable statute.

2004 Amendments Temper Employee Rights and Restore Some Employer Rights

Fortunately, the current Legislature acknowledged the problems created by the law and on July 29, 2004, passed several key amendments. Governor Schwarzenegger signed the new law on August 11, 2004, and it became effective the next day. Of particular significance, certain of the amendments are retroactive to January 1, 2004, and should extinguish any claims filed under the original law that could not be pursued under the amended law.

The new law contains important changes that should help eliminate many of the more frivolous claims technically allowed under the original Act. In particular, an employee may no longer recover penalties for violations of posting, notice, reporting or filing requirements under the Labor Code, except where the filing or reporting involves mandatory payroll or workplace injury reporting. These are among the provisions retroactive to January 1, 2004.

Although still imposing penalties for Labor Code violations, the new law also gives courts the discretion to award less than the maximum penalty against the employer if, "based on the facts and circumstances of the particular case, to do otherwise would result in an award that is unjust, arbitrary and oppressive, or confiscatory." This grant of discretion seems to be a clear invitation by the Legislature for courts to assess whether the employee is pursuing a particular action to vindicate important rights or simply to line his or her pockets at the employer's expense. The court then may adjust the penalty accordingly. This provision also may influence the determination of what constitutes a "reasonable" attorney's fee in the circumstances. Unfortunately, prevailing employers still are not allowed to recover their attorney's fees.

The new law requires that, before filing a civil action relating to three general categories of Labor Code violations, an employee must give both his or her employer and the appropriate state agency written notice of the alleged violation and a statement of the supporting facts and theories. The agency and pertinent procedures are different for each:

Three Categories of Violations Require Notice, Allow Employer Some Opportunity to Cure

The first category of violations involves wage and hour provisions, as well as other statutes governing conditions of employment, and the employee must notice the Labor Workforce Development Agency (the "Agency"). The complaining employee may then file a lawsuit **only after** the Agency fails or decides not to commence its own investigation or to cite the employer, or commences an investigation but ultimately fails to issue a citation within 158 days.

> *The Act gave employees the right to sue their employers and collect money penalties for even the most minor violations of specified California Labor Code sections…*

The second category of violations involves workplace safety-related matters. The Division of Occupational Safety and Health ("DOSHA") is the agency responsible for investigating such violations. If, after notice, DOSHA investigates and issues its own citation, the employee is barred from filing an action. If DOSHA investigates, but does not issue a citation, then the employee may challenge that DOSHA decision in court. If DOSHA fails to inspect or investigate, then before filing a lawsuit the employee must follow the procedures applicable to the third category of violations.

The third category involves violations of the other Labor Code sections enumerated in the Act, as well as DOSHA failures to inspect or investigate. For these violations the employer has the opportunity to cure the asserted violation, that is, to address the complaint and make whole any employee who was damaged by the violation. If the

employer fails to do so, or if after investigation the Agency concludes that the employer has not cured the violation, then the employee may file a civil action. If the Agency concludes that the employer has cured the violation, then the employee may appeal that decision to the superior court.

Because in asserting a violation the employee must comply with prior notice requirement, the employer has an opportunity to take action to correct the problem if one exists. Even in circumstances where the employee still is able to file a lawsuit despite the employer's efforts at correcting the problem, the effort still should be made. Positive actions by the employer may well influence the court's decision as to whether to award less than the maximum penalty, and how much to award as a "reasonable" attorney fee.

The requirement that the complaining employee involve the appropriate state agency before filing a complaint puts a premium on responding promptly and effectively to agency inquiries. Resolving problems at the agency level will help the employer avoid — or at least minimize — costs of employee litigation. Even when the agency determination does not eliminate the employee's right to sue, it seems unlikely that an employee would pursue a private lawsuit even after a resolution acceptable to the agency has been reached.

The new Act carries over the penalty provisions from the prior law, and these can be significant: $100 to $200 per employee for each pay period during which a violation is found. Also, one employee may pursue claims on behalf of all other "aggrieved" employees.

Finally, the new law abolishes an existing requirement that employers file with the Director of Labor Standards Enforcement a copy of any employment application that the employer requires applicants to sign. Existing law also prohibits employers from discriminating against employees for exercising certain rights, and exercising rights under the Act is now added to that list.

Good News and Bad News

The new law, while probably not a perfect remedy from the perspective of many employers, still offers real procedural protections from the frivolous or curable violations not incorporated in the original statute. Just how effective those improvements are should become clearer in the next several months.

In the meantime, employers should take sensible, preventive measures, including reviewing compliance with applicable wage and hour requirements (including overtime payment and exempt/non-exempt classifications), making sure that all employees are taking required breaks, and assessing compliance with workplace safety and health requirements. Not only will such a review help prevent future problems, it also will help demonstrate the employer's good faith — and potentially reduce any award of penalties or attorney's fees — should the employer later face a claim under the Act.

Positive actions by the employer may well influence the court's decision as to whether to award less than the maximum penalty.

Because of the complex nature of the legislation and its administrative and procedural requirements, an employer should consult closely with a specialist in employment law capable of guiding the employer successfully through the process.

Legal Alert!

CONTINUED FROM PAGE 1

The new law is far-reaching, and gives Domestic Partners, for example, the right to:

1. adopt a child jointly,
2. treatment as spouses under worker's compensation and public assistance and
3. to inherit as spouses in the absence of a Will.

Under this new law, in the event that the partners decide to terminate their domestic partnership, they will be subject to the same Court oversight as a married couple governing the dissolution of marriage and the division of property. Spousal support and child custody will also be within the jurisdictional purview of the Court.

…the most significant change is the automatic accrual of community property effective from the original date of the domestic couple's registration.

Unquestionably, the most significant change is the automatic accrual of community property effective from the original date of the domestic couple's registration. In order to opt out of this new community property regime, a registered couple must enter into a formal written property agreement by June 30, 2005. California Domestic Partners must familiarize themselves with their new rights and obligations.

Because this new law does not affect or alter any federal laws, domestic partners cannot claim the same tax and pension breaks as married couples. It is also possible (although fairly remote) that the new community accumulation rights of domestic partners will create a gift liability to the domestic partner who earns the larger compensation. Only time will tell.

IRS SECTION 1031 — TAX-FREE EXCHANGES OF REAL PROPERTY

CONTINUED FROM PAGE 1

The rules are intricate, however, and care must be taken in structuring an exchange. Tax will be payable on "boot," that is, non-qualifying property received in the exchange such as cash or relief from mortgage liability in excess of the liabilities on the replacement property.

QUALIFYING TRANSACTIONS

The good news is that just about any kind of real property (other than an owner-occupied personal residence) can qualify as "like kind" for purposes of Section 1031. For example, a taxpayer can exchange vacant property for developed property, or exchange industrial property for commercial or investment residential property.

Certain types of property, such as stock in trade or property held primarily for sale, do not qualify. Therefore, a taxpayer engaged in the business of buying and selling real properties (such as a developer) will normally not qualify.

Multiple 1031 exchanges, involving rollovers from one replacement property to another can defer the tax consequences for as long as the property owner wishes.

As a general matter, federal case law in the 9th Circuit Court of Appeals, which has jurisdiction in California, and various statutory revisions over the years have improved taxpayers' ability to enter into Section 1031 exchanges. For example, although Section 1031 specifically excludes interests in partnerships for exchange treatment, a partnership can still, under certain circumstances, enter into an exchange and qualify under Section 1031 for non-recognition of gain.

The 9th Circuit has held that a partnership can dissolve and the qualifying property (now held as tenants-in-common interests by the former partners) can be exchanged for other qualifying property and satisfy the test for non-recognition treatment. Exchanges of qualifying real property and a subsequent transfer into a partnership may also enjoy non-recognition treatment.

Similarly, it appears that a distribution from a corporation followed by exchanges and exchanges followed by a contribution back to the corporation may also qualify for Section 1031 treatment under the right circumstances. Although the IRS has not yet officially accepted this transaction structure, a properly structured transaction should withstand any IRS challenge.

The 9th Circuit "Starker" case and certain statutory revisions to Section 1031 have introduced greater flexibility in making tax deferred exchanges. It is now possible to dispose of qualifying real property and later acquire the replacement real property (a "delayed exchange") or acquire qualifying real property and then later dispose of preexisting qualifying real property (a "reverse exchange") and still qualify for Section 1031 treatment. The delayed exchange is now very common and allows a current sale of your property through an "Accommodator." After the initial sale, the Accommodator can acquire and transfer to the real purchaser the property designated as the replacement property.

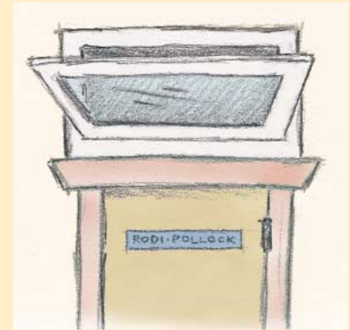
Tenancy-in-Common interests ("TICs") can also qualify for Section 1031 benefits. Developer entrepreneurs have prepackaged properties that are under long-term triple net leases to high-quality tenants and are offering TICs as exchange properties.

TICs offer several attractions: A property owner seeking Section 1031 treatment who cannot find qualifying replacement property within the required time frame can select a TIC as the replacement property and then use the TIC later as exchange property for a subsequent acquisition. Furthermore, a property owner who no longer wishes to manage his or her investment property can exchange that property for a TIC and thereafter simply receive an income stream without incurring a tax on the sale of the investment property.

Multiple 1031 exchanges, involving rollovers from one replacement property to another can defer the tax consequences for as long as the property owner wishes. Indeed, if the property owner defers the taxability of the property until his or her death, the tax *deferral* becomes tax *avoidance*. As an added bonus, IRC Section 1014 steps up the basis of all estate assets, including exchange property, to the value at the owner's date of death.

Section 1031 provides a wonderful tool for tax deferral. If we can be of service in this area, please call us.

A PEEK THROUGH THE TRANSOM AT RODI POLLOCK



Our labor and employment law department provides litigation and counseling services in all labor and employment areas including wrongful termination, employment discrimination, sexual harassment, overtime and other wage/hour matters, ERISA matters, employee discipline, training, employee handbooks and policies and procedures. We also represent employers in traditional labor law matters involving relationships with unions such as collective bargaining negotiations, grievances and arbitrations, and responses to union organizing.

Our two principals whose practices are primarily labor and employment law are Al Klein and Patrick Cain. Al and Pat put on programs for various employer groups, and have received excellent reviews for their program entitled "How to Fire Someone… Without Getting Sued." You can contact Al or Pat directly if you are interested in their services or in attending one of their programs.