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- Discharge of Real Property Indebtedness Income
- Recent Estate Tax Developments
- Employment Law Basics: Employment-at-Will

Winter, 2009

## Asset Protection in Tough Economic Times

*Paul Chmielewski, Esq., LL.M.*

The U.S. economy continues to face tough economic times. This has brought the importance of asset protection back to the forefront for many of our clients. A major concern is when assets are owned in an individual's name. This allows creditors to seize the individuals' assets to satisfy claims against the individual. Several entities can be created to help shield your assets from creditor claims. Two commonly used asset protection strategies are as follows:



**Limited Liability Companies (“LLCs”) or Family Limited Partnerships (“FLPs”).** LLCs with two or more members and FLPs (which must have two or more partners) prevent an individual's creditors from seizing assets owned by the entity or from making any management decisions involving the entity. Instead, creditors are provided with a “charging order” that entitles them to receive distributions, if any, made to the debtor partner/member. Because it cannot participate in entity management decisions, there is no way for a creditor to force distributions to be made to the debtor partner/member.

LLCs and FLPs are often created to hold real estate and liquid investments as well as active businesses. Liability for separate assets, such as multiple pieces of rental real estate, can be further segregated through use of subsidiary entities. If properly structured, the income and expenses of the subsidiary entities can be reported on the income tax return of the parent, thereby avoiding the need for multiple tax returns to be filed.

**Irrevocable Trusts (“IT”).** Unlike revocable living trusts, ITs are a valuable way to achieve asset protection provided the person creating the trust (“grantor”) does not maintain control or use of the trust assets. In addition, an IT can be structured to prevent creditors of the trust beneficiaries (i.e., family members of the grantor) from seizing assets owned by the trust. Although an IT requires a grantor to give up control and use of the asset, some people are willing to give up a portion of their estate to ensure that the transferred assets are never subject to their creditors' claims in the future.

ITs in which the grantor maintains an income interest (“self-settled trusts”) and offshore trusts have been heavily hyped as litigation proof. In reality, many of the advertised benefits of these types of trusts are non-existent and these types of trusts provide extremely limited, if any, asset protection.

The strategies discussed above are valid only if implemented before a pending claim exists. If assets are transferred after a pending claim arises, the transfer will be likely be deemed a fraudulent conveyance and be subject to creditor claims. Early planning is a key element in asset protection.

## Discharge of Real Property Indebtedness Income

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In our firm's recent Special Edition newsletter, we mentioned that up to \$2,000,000 of discharged debt related to a taxpayer's primary residence is exempt from income tax. Although this exemption is helpful, it is limited to a very specific segment of property owners. In these challenging economic times, many properties that are not primary residences are being foreclosed on, returned to the lender via deeds in lieu of foreclosure or are being sold as short sales. These property owners are forced to look for other options to avoid taxation on the value of the debt that is forgiven.

Generally, discharge of indebtedness is reportable as income. However, for all entities other than a C corporation, discharged debt that is classified as "qualified real property indebtedness" is excluded from a taxpayer's gross income to the extent that the forgiven principal balance exceeds the fair market value of the property securing the indebtedness. Instead, the portion of qualified discharged debt reduces the basis (but not less than the aggregate adjusted bases) of the depreciable real property held by the taxpayer immediately before the discharge.

Qualified real property indebtedness is defined as indebtedness that:

- was incurred or assumed by the taxpayer in connection with real property used in a trade or business,
- if incurred after January 1, 1993, the debt must be "qualified acquisition indebtedness," and
- debt for which the taxpayer elects to qualify as "qualified real property indebtedness."

"Qualified acquisition indebtedness" is defined as debt incurred or assumed to acquire, construct, reconstruct, or substantially improve such property. "Indebtedness of the taxpayer" means any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property.

For partnerships and limited liability companies, the exclusions and elections discussed in the previous paragraph are applied at the partner level (for S corporations, the exclusion is taken at the corporate level). This means that a partnership or LLC has to account for the discharged debt as income but should receive an offsetting distribution when it distributes that income to the partners on their K-1s. The partners can then elect to exclude the discharged income reported on their K-1s from income tax. If a partner elects to exclude discharged income from taxation, certain basis adjustments are required to be made to the partner's partnership or LLC interest.

The election to exclude discharge of indebtedness from income must be made on the timely-filed (including extensions) federal income tax return for the taxable year in which the taxpayer has discharge of indebtedness. The options discussed above are not applicable if a party files bankruptcy. Special rules apply to a discharge of debt in bankruptcy.

**"Generally, discharge of indebtedness is reportable as income."**

*The information in this newsletter is not intended or written to be used and cannot be used by any taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. The articles have been written to support the promotion or marketing of the transactions addressed by our attorneys. Taxpayers should seek advice based on their individual circumstances from an independent tax advisor.*

## Recent Estate Tax Developments

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It has long been suspected that the repeal of estate taxes in 2010 and the reimposition of such taxes in 2011 would be modified in some manner. As expected, Congress has taken the first step in eliminating the scheduled repeal of estate taxes in 2010. In January 2009, U.S. Representative Earl Pomeroy (D-ND) proposed H.R. 436. H.R. 436 seeks to maintain the current estate tax exclusion amount of \$3,500,000 indefinitely rather than repeal the estate tax in its entirety in 2010.

H.R. 436 also seeks to eliminate a widely used estate planning strategy involving gifts to family members. Historically, family gifting entities ("FGEs"), such as family limited partnerships, were used to transfer family assets from parents to children. The advantage in transferring assets via FGEs was that the gifted FGE interests were entitled to a discounted gift tax value due to lack of control and lack of marketability. Therefore, a gift of assets with an underlying value of \$1,300,000 might only be valued as a gift of \$1,000,000 due to discounting. This allowed a parent to transfer a greater share of assets out their estate at a lower gift tax valuation. Under H.R. 436, a parent would not be allowed to claim a discounted gift tax valuation for gifts of interests in FGE that own stocks, bonds or other passive assets, including certain types of real estate. This would eliminate the use of FGEs as an estate planning device for many intra-family transfers of assets. As drafted, H.R. 436 is applicable to transfers made after the enactment date of the bill. The future effective date of the bill provides a brief span in which to transfer FGE interests now and still obtain a minority discount.

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There is no way to tell whether or not H.R. 436 will be enacted. Furthermore, if H.R. 436 is enacted, there is no way to be certain that it will be passed in its current form. Regardless, it appears that there is support for changes to the current estate tax laws. If estate tax planning is a concern, you may want to contact a competent advisor to determine if you can benefit from any options available under current law. If you wait, there is no guarantee they will be available when you decide to implement them.

## Employment Law Basics

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In the United States, employees who serve an employer without a written contractual agreement generally can be fired for any reason. This is called "employment-at-will." Federal and state statutes, such as Title VII, the Americans With Disabilities Act, and numerous other similar acts provide statutory restrictions on the ability to fire employees for any reason. However, in addition to these statutory restrictions, state courts have created three common law exceptions to the employment-at-will doctrine in order to prevent other possible wrongful terminations. This article discusses these three exceptions to employment-at-will with respect to Colorado law.

**Public Policy Exception.** Under the public policy exception, a discharge of an employee is wrongful when the discharge goes against well-established state policy. For example, an employee cannot be fired after making a workers' compensation claim, or after being requested by the employer to perform an illegal act. Colorado restricts these "public policy" cases to those where the public policy is clear and stated in the state constitution or statutes. Other states may have a more expansive view of public policy.

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## **Employment Law Basics, Cont.**

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***Implied-contract Exception.*** Another exception to the at-will doctrine arises where an implied contract is created between the employee and the employer. In such cases, though no express or written agreement between the parties, or implied contract can be created through statements made in the employee handbook or through oral or written statements to employees regarding long-term job security or discharge procedures. Colorado courts recognize, however, that the employer can make an explicit statement in the handbook that the handbook does not create contract rights. The best practice for employers is to make a clear statement in the handbook that statements in the handbook do not constitute an implied contract between the employee and the employer.

***Covenant of Good Faith.*** Every contract in Colorado includes a covenant of good faith and fair dealing. This means that where one party is given discretionary authority in the contract, that discretionary authority must be exercised reasonably and consistent with the purposes of the agreement. However, Colorado courts have explicitly refused to recognize the covenant of good faith and fair dealing in employment relationships. If the covenant of good faith and fair dealing did apply in employment relationships, this would be a major blow to employment-at-will relationships. In effect, applying good faith and fair dealing concepts to employment-at-will might mean that employers could terminate employees only for “just cause.” It does not appear likely that Colorado will change the exception any time soon.

Pressing economic times sometimes require difficult decisions on the part of employers with regard to employment relationships. Generally, absent written contracts, the employment-at-will doctrine applies, and employees can be terminated for any reason that is not one of the exceptions to the employment-at-will doctrine, and does not violate federal or state statutes.