insights

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A Newsletter from Shumaker, Loop & Kendrick, LLP | Spring 2015

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THE IMPORTANCE OF ACCREDITED INVESTORS FOR

Small Business Capital Formation

Small businesses are often regarded as the catalyst for economic growth in the United States. Small businesses account for the creation of two-thirds of all new jobs, and are the incubators of innovation. The majority of new jobs in the U.S. are from companies less than five years old. Raising capital is a never-ending imperative for small businesses at every turn: to explore new ideas, to exploit a new development, to expand the scope of research, to move from concept to prototype to marketable product, for manufacturing, distribution and marketing. At the beginning of their life cycles, this funding is provided by private money–initially from friends and family, then from a wider circle of acquaintances, later, perhaps, from angel investors and, ultimately, venture capitalists and private equity groups. Angel investors, for example, provide approximately 90% of outside equity raised by start-up companies and are virtually the only source of seed funding. In 2013, angels invested $25 billion in 71,000 companies.

By Gregory C. Yadley

Raising the money requires compliance with the federal securities laws and the corresponding securities laws of the various states. The primary rule: register the securities offered and sold with the U.S. Securities and Exchange Commission ("SEC") and the securities commissions of the states in which such offers and sales are made *unless* an exemption from registration is available. There are numerous exemptions for private offerings, intra-state offerings and those limited in terms of the amount of capital raised, the number of offerees or purchasers, and the character of the investors. As registration is time-consuming and expensive, smaller companies' success in raising capital is highly dependent on identification of one or more funding sources that qualify as an "accredited investor."

In particular, Rule 506 under the SEC's Regulation D is the Holy Grail, providing two paths for companies to raise unlimited amounts of money with a minimum of filings, mandated disclosure and other regulatory burdens. Rule 506(b) exempts offerings from registration where "private" sales are limited to accredited investors and up to 35 non-accredited investors. In 2011, the estimated amount of capital raised in Regulation D offerings (overwhelmingly under the Rule 506 exemption) was more than $1 trillion, about the same as was raised that year in public offerings. From September 23, 2013-September 22, 2014, there were almost 15,000 new Regulation D offerings, nearly all under the Rule 506(b) exemption. Beginning in late 2013, with the amendments to Regulation D mandated by the "JOBS Act," new SEC Rule 506(c) exempts offerings from registration in "public" sales to accredited investors where the issuer has taken reasonable steps to verify such accredited status. Significantly, qualification for exemption under Rule 506 means that the issuer does not have to comply with

any substantive requirements of the states in which the securities are sold. The definition of "accredited investor" is contained in Rule 501(a)(5) and includes eight types of entities and individuals. For natural persons to be deemed accredited they must meet certain income or net worth thresholds.

Accredited investors were not counted within the numerical limit of 35 purchasers for Rule 506, were not required to meet any "sophistication" standard, and were not required to be given any of the otherwise obligatory disclosures. Regulation D, with its concept of accredited investors, became effective on April 15, 1982. Since that time, with one exception, the definition has remained unchanged. In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), enacted in the wake of the financial crisis, sought to protect investors by expanding the protective buffer against potential economic loss of investing in private placements. The Dodd-Frank Act mandated the elimination of the investor's equity in his or her primary residence from the computation of the $1 million net worth test.

The Dodd-Frank Act required that the SEC review the accredited investor definition every four years, beginning in 2014, to determine whether it should be adjusted.

The Dodd-Frank Act required that the SEC review the accredited investor definition every four years, beginning in 2014, to determine whether it should be adjusted. In doing so, the agency has the benefit of numerous public comment letters as well as a Dodd-Frank Act mandated study by the U.S. Government Accountability Office ("GAO") and guidance from three well-informed and credible groups whose views should carry significant weight: two of the SEC's own advisory committees and the SEC Government-Business Forum on Small Business Capital Formation. Perhaps not surprisingly, the views of these diverse groups are not entirely in harmony.

Nevertheless, in reviewing and considering the information before it, this author believes the SEC would be well-advised to consider these fundamental points:

- The current "accredited investor" definition is clearly understood by investors and companies using Regulation D to raise funds in private placements, primarily under Rule 506.
- Rule 506 has worked well since 1982, and no significant fraud or abuse has been specifically traced to its use.
- Small business capital formation is critical to the health and growth of the U.S. economy and the creation of new jobs.
- Replacing a simple, objective, well-understood rule with something more complex and subjective that would significantly restrict the available pool of capital for small business is not justified.
- Any change to the accredited investor definition should be based on hard evidence, and changes should be phased in to avoid disruption to the private capital markets and the businesses that depend on them for funding.

It is undisputed that the federal securities laws must balance the needs for capital formation and investor protection. Confidence in the capital formation process is important, and finding the right

balance is never easy. How one views the definition of accredited investor depends largely upon from which camp one sets out. How much protection should the government provide against loss? More importantly, how involved should the government be in determining how much risk an individual should take?

The answer to how much regulation is appropriate is elusive. The path to resolution, however, is simplified if we start from–and follow– the second basic tenant of securities law: *Provide the investor with complete and accurate information about the issuer and the securities being issued.* While this leaves some room for fraud, no law or regulation, however comprehensive or onerous, can eradicate fraud.

Regulation D and the current accredited investor definition work. Perhaps inclusion of an inflation adjustment from here on out would be appropriate. It may not be necessary, but logic suggests that a fixed number cannot always be "right" over a lengthy period of time. However, given the absence of evidence of significant fraud, incorporating an inflation adjustment back to 1982, as has been proposed by some commentators, would be foolish and unnecessary. According to SEC data, to impose an inflation adjustment on the current thresholds from the implementation of Regulation D to the present would require increasing the net worth threshold from $1 million to $2.5 million and increasing the net income standard from $200,000 to $493,000. The Angel Capital Association has indicated that, if the net worth threshold were raised to that extent, approximately 32% of its members outside of California and the New York/New England area would not quality.

Allowing some alternative qualification of an individual as an accredited investor, based upon his or her knowledge and experience–a "sophistication" criteria"–also makes sense. Some reasonable criteria have been offered, including the following:

- prior board, executive or financial responsibility;
- relevant training or degrees, such as a CPA, CFA, MBA, JD;
- licensure as a broker-dealer or investment advisor;
- membership in an established angel group;
- previous investment experience in private offerings; and
- qualification through passing a test or completing a questionnaire.

In my view, the standard should address primarily an understanding of basic business and finance, including the risks of investing in securities. One does not have to be an accountant to invest in a bank stock or a geologist to invest in a mining stock. In some cases, it is virtually impossible for anyone to truly understand the likelihood of success or failure of the venture. Until such time as an individual has become "wealthy" (by meeting the accredited investor income or net worth thresholds), it may be sufficient if someone has a basic understanding of business and finance, and some knowledge or experience in the sector or industry in which the company operates or the investment scenario to be pursued.

While there is some appeal in providing new non-financial qualifications, the SEC should be cautious in adopting a percentage of liquid investments or similar test. In addition to the difficulty in where to set the percentage, the result can be unduly limiting. For example, if an individual's first investment is unsuccessful, he or she could be prevented from undertaking a second investment. Diversification is a primary rule of investing and even angel investors are successful only a minority of the time.

Special protection for senior citizens is also an elusive and perhaps illusory objective. Admittedly, the elderly generally live on fixed incomes, become anxious more easily and their cognitive acuity declines at some age–but not necessarily at the Rubicon age of 65. Since first round financing for new businesses is from "friends and family," curtailing or restricting parents and grandparents from financially assisting their families is bad for the economy and unwarranted.

Excluding "retirement assets" from the calculation of net worth is also problematic. Retirement assets are not a separate asset class and, for persons as they advance in age, *all* assets are, in fact, retirement assets. In any event, senior citizens under current law can deplete their "retirement assets" without penalty, including by day trading in securities of public companies on a registered securities exchange.

Mandating the use of an investment advisor for certain accredited but less sophisticated investors, including senior citizens, has been recommended. Philosophically, this state paternalism has little appeal to many and for those who support such protection, agreement on where to draw the lines may be elusive. Beyond those issues, and the additional expense (and risk to the advisor), there is little data to indicate that an investment advisor would improve the likelihood of a successful investment.

The SEC has, thus far, taken the necessary time and been methodical in attempting to obtain the information and input to make a reasoned judgment as to how to modify the accredited investor definition. The agency should be at the point soon when it can do so. When the SEC acts, I hope that it will agree, as expressed in this article, that "less is more."

* An expanded version of this article was presented at the 33rd Annual Federal Securities Institute in Miami, Florida on February 6, 2015. The author would be pleased to provide a copy of the original article upon request.

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"All Appropriate Inquiries": Update on the Environmental Due Diligence Standard

Environmental due diligence is a critical aspect of any project involving a transfer of real estate. Conducting a compliant Phase I Environmental Site Assessment is typically the first step in that process. This article explains how the Phase I became an industry standard for making "all appropriate inquiry," and presents changes that are required in light of recent modifications to a key federal environmental statute.

Background

In 1980, Congress enacted a broad and sweeping environmental law known as the Comprehensive Environmental Response Compensation and Liability Act ("CERCLA"). CERCLA provides extensive federal authority for governmental agencies to respond directly to releases or threatened releases of hazardous substances into the environment. Specific provisions of CERCLA also permit the government to pursue current owners for response costs, even if that owner did not cause the contamination at issue.

By Mark E. Mercer

One of the consequences of CERCLA was that purchasers and developers of real estate began to avoid sites associated with historic contamination, also referred to as brownfields, due to the potential significant liabilities.

One of the consequences of CERCLA was that purchasers and developers of real estate began to avoid sites associated with historic contamination, also referred to as brownfields, due to the potential significant liabilities. In 2002, CERCLA was amended to provide incentives to redevelop brownfields as well as to afford certain liability protections for innocent landowners, contiguous property owners, and bona fide prospective purchasers.

"AAI" and the ASTM Phase I Standard

In order to qualify for CERCLA liability protections, the purchaser of potentially contaminated property must take "all appropriate inquiries into the prior use and ownership at the property." *40 CFR part 312*. The rule also describes what is required for conducting all appropriate inquires, or "AAI," and importantly recognizes that complying with ASTM 1527-05 "Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment" satisfies AAI. The American Society for Testing and Materials ("ASTM

International") is a widely recognized private international organization that develops and publishes technical standards for a wide range of industries, materials and products. ASTM 1527-05 itself details the technical requirements for conducting an appropriate Phase I ESA including, among other things, a site inspection, records review, interviews, and the preparation of a written report.

The 1527-05 standard was modified in 2013 after extensive comment and published as 1527-13. U.S. EPA adopted the standard as compliant with AAI and recognized that 1527-13 "reflects evolving best practices, affording prospective owners essential information when making property transaction decisions."

Initially, U.S. EPA approved the use of either 1527-05 or 1527-13 to comply with AAI. Ultimately however, the agency concluded that AAI should be revised to only reference 1527-13. The change to AAI was made, in part, based on a desire to reduce any confusion associated with referencing a standard no longer recognized as good customary business practice.

The effective date of the change to AAI, referencing only 1527-13 as meeting the standard for CERCLA liability protections, is October 6, 2015. The delay in the effective date is to allow those who may currently be using 1527-05 to complete work and still comply with AAI.

Changes to AAI

ASTM 1527-13 contains several changes, several of which are described below, which are now incorporated into the AAI rule:

- Vapor Intrusion: Phase I reports must include an evaluation of potential migration into buildings and structures. Such migration may occur when subsurface contamination moves through the soil and into buildings which could present potential health and exposure risks *(ASTM 1527-35 3.2.56).*
- Regulatory File Reviews: Environmental professionals should review regulatory files if the subject site or adjacent property is identified in the governmental database records. A review of the physical files is meant to assist with confirming if environmental impacts actually exist at the site associated with the listing *(ASTM 1527-13 8.2.2).*
- Controlled Environmental Conditions: The Phase I standard includes a category for "controlled recognized environmental conditions." This added term allows an environmental professional to identify with greater particularity those situations where a site has been cleaned up, but some contamination was allowed to remain in place subject to controls (i.e., activity use limitations, engineering controls, institutional controls, etc.) to the satisfaction of the regulatory authorities *(ASTM 3.2.18)*. This update is helpful with the more and more impacted sites conducting "risk based" closures.

Conclusion

Performing a Phase I Environmental Site Assessment is an important step in any real estate transaction. Such work not only provides important information about history, limitations, and potential liability associated with a site but also can be used to establish a defense to CERCLA liability. Buyers, sellers, and lenders should be aware of the changes to AAI and its effective date as well as revisions to the Phase I standard which are reflected in ASTM 1527-13. Additionally, contracts, policies, and agreement forms should be updated to reference the updated ASTM standard.

For more information, contact Mark Mercer at mmercer@slk-law.com or 419.321.1436.

A Hunt for Justice
Erodes the Attorney-Client Privilege

In a highly regulated environment, it is challenging for U.S. corporations to maintain 100% compliance with each and every law touching them. When issues arise, U.S. corporations rely on the ability to have full and frank discussions with their legal counsel to assess risk and take corrective action to minimize loss. The ability to have such private discussions is based on the attorney-client privilege, which prohibits legal counsel from divulging privileged communications to any third party.

By David H. Conaway

and Joshua M. Hayes

Although the attorney-client privilege is quite strong, one of the world's largest public companies learned it is not absolute. The Delaware Supreme Court, in *Wal-Mart Stores, Inc. vs. Indiana Electrical Workers Pension Trust Fund IBEW*, ruled that in-house counsel's legal advice to management was not protected by the attorney-client privilege.

The Delaware Supreme Court, in *Wal-Mart Stores, Inc. vs. Indiana Electrical Workers Pension Trust Fund IBEW,* ruled that in-house counsel's legal advice to management was not protected by the attorney-client privilege.

Background Facts

In 2012, the *New York Times* reported about a scheme of alleged illegal bribery payments from Wal-Mart's Mexican subsidiary, Wal-Mart de Mexico, S.A. de C.V. ("WalMex") to Mexican government officials, allegedly at the direction of WalMex' then CEO. The *New York Times* indicated that Wal-Mart management knew about the allegations as far back as 2005 and attempted to "whitewash" any evidence of illegality.

Wal-Mart conducted an internal investigation, led by WalMex' general counsel, who concluded that there was no evidence of wrongdoing. In response, a Wal-Mart shareholder, owning less than ½% of Wal-Mart's stock, initiated an investigation, in furtherance of asserting claims against Wal-Mart's officers and directors for breaches of fiduciary duties owed to shareholders. As part of the investigation, the shareholder sought production of documents and communications between in-house counsel and management under Title 8, Section 220 of the Delaware Code, which allows shareholders to review books and records for a

"proper purpose." Wal-Mart refused production, based on the attorney-client privilege. The shareholder, in turn, requested the Delaware court to compel turnover.

Delaware Court Ruling

In ruling that the attorney-client privilege did not protect the documents and communications, the *Wal-Mart* court relied on an exception to the attorney-client privilege, which was first recognized over forty years ago in the Fifth Circuit U.S. Court of Appeals opinion in *Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970). The so-called *Garner* exception arises in shareholder suits alleging officer or director actions that are adverse to the shareholders' interests. In such cases, shareholders can obtain privileged information to establish facts to support claims for the breach of fiduciary duties by officers or directors. To prevail, shareholders must demonstrate "good cause" based on several factors, including:

- the number of shareholders and the percentage of stock they represent;
- the "bona fides" of the shareholders;
- the nature and viability of the shareholders' claims;
- the necessity of having the information and its availability from other sources;
- whether the alleged actions potentially criminal or illegal;
- whether the communication related to past or to prospective actions;
- whether the communication relates to the alleged wrongdoing or the litigation itself;
- whether the communication is identified or a fishing expedition; and
- the risk of public disclosure of trade secrets or other confidential information.

The Delaware Supreme Court found that the pension fund showed "good cause" to apply the *Garner* exception because essential information was not available from non-privileged or public sources. The Court attempted to balance the competing interests of preventing corporations from hiding corporate wrongdoing and preserving open and honest communication between in-house counsel and their corporate clients. While the Delaware court recognized that the attorney-client privilege is essential in allowing clients to freely discuss possible legal issues with counsel without fear of legal discovery, the Court believed that corporations could abuse the privilege and purposefully conceal evidence of wrongdoing. The court noted, however, that any exception to the attorney-client privilege should be "narrow, exacting, and intended to be very difficult to satisfy." If a corporation is committing wrongful acts, the harmed shareholders should be able to evaluate the acts of the corporation.

Although U.S. state courts have been split on the *Garner* exception, its adoption by the influential Delaware court will no doubt reinforce the *Garner* exception in future shareholder litigation.

Ancillary Actions

In connection with the alleged Mexican bribery payments, the U.S. Department of Justice and the Securities and Exchange Commission have ongoing investigations of Wal-Mart's activities that began in November 2011.

There is also a shareholders' securities fraud class action case against Wal-Mart in Arkansas federal court. Thus far, the SEC has refused to turn over to Plaintiff materials developed in the SEC's investigation.

Takeaways

1. The *Wal-Mart* case dealt with in-house counsel. As a result of the holding, similar challenges to attorney-client privilege are likely to arise with respect to external counsel, which could lead to this same outcome. Consequently, shareholders in Section 220 and derivative suits in Delaware may now be entitled to production of both in-house and outside counsels' work-product and communications relating to alleged breaches of fiduciary duty, including documents produced during the course of an internal investigation.
2. In the post-financial collapse era, scrutiny of corporate activity is certainly elevated. It is likely that courts faced with any corporate action involving criminal or illegal corporate activity will more readily apply the *Garner* exception and waive the attorney-client privilege. Perhaps "lesser" breaches of fiduciary duty might withstand the *Garner* exception.
3. Arguably the risk of illegal activity is greater in foreign jurisdictions where "rogue" managers or officers are operating in a less disciplined environment. U.S. corporations would be well advised to focus on a vigorous corporate policy and training including with respect to the U.S. Foreign Corrupt Practices Act (and other countries' versions of the same).

4. It may also be advisable for U.S. corporations to consider in appropriate cases confidentiality agreements and arbitration clauses with shareholders that could limit disclosure of privileged information, as an effort to protect legitimate confidential commercial information, and head off additional investigations by various U.S. government agencies.
5. The *Wal-Mart* case also illustrates the difficult position of corporate counsel, when confronted with the ethical obligation to not divulge communications while being a target of investigators or prosecutors seeking the information. To protect counsel and their employers, companies should consider strategies on evaluating and investigating allegations of illegal activity, including (1) memorializing (or not) results of investigations, (2) limiting the number of parties involved in the process, (3) protecting information as attorney-client privileged or attorney work product, and (4) involving third parties to conduct investigations.

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DATA BREACH:

Every Business Needs an Elite Goalie

The days of standing behind someone at the grocery store who is paying with a personal check, or, around the office, hauling physical paper files, are essentially extinct. To many Americans, the cash register and filing cabinet are now antiques. The cost-effectiveness and efficiency brought by e-commerce and digital business now saturates the U.S. and will only continue to increase with time. The rise of cloud computing infinitely expands the information landscape. The reality that critical confidential information is disseminated on a wider scale than ever before generates growing security concerns for consumers, business owners and the government.

By Michael S. Taaffe

and David L. Wyant, Jr.

The reality that critical confidential information is disseminated on a wider scale than ever before generates growing security concerns for consumers, business owners and the government.

Approximately two-thirds of all American adults have a smartphone. A 2014 study determined that the average American spends 162 minutes per day on their cellphone and that the average individual checks the cellphone more than 150 times per day. According to the U.S. Census Bureau, in 2013, 74 percent of all households reported Internet use. The U.S. reported over $300 billion in e-commerce in 2014, which is projected to rise by at least $50 billion this year. These figures have all grown tremendously over the last decade.

With the proliferation of employees having access to confidential and proprietary data in the increasingly commonplace American digital workplace, the security of this data in the employment context has become as crucial an issue as the one that has grabbed more headlines–the protection of consumer data in e-commerce. A staggering 94% of American jobholders are Internet users. In the workplace, employees rank the importance of Email above the Internet, landline telephone, cellphone and social networking sites. Americans are not only connected at the workplace, but are very often also connected via electronic devices in their pockets or homes (employer-issued or not)–be it a cellphone, computer, tablet, or other Internet-capable device. In 2014,

companies reported a 10% increase in "insider" incidents perpetrated by employees or former employees, solidifying such incidents as the most common of all regarding data breach.

In addition to the highly-publicized consumer data breaches occurring during the last six months at large retailers Target and Home Depot, the recent news of breaches at the second-largest health insurance company in the U.S., Anthem Inc., as well as the breaches at major financial institutions like JPMorgan, shows the compromise of millions of Americans' most sensitive information. In 2013, 19% of U.S. businesses reported losses of $50,000 to $ 1 million due to data breaches. Regardless of breach size, the American government recognizes that data security is a pressing issue.

In his 2015 State of the Union address, President Barack Obama said, "No foreign nation, no hacker, should be able to shut down our networks, steal our trade secrets, or invade the privacy of American families, especially our kids." The White House has taken the lead on the proposal of federal legislation to address cybersecurity and data breach. Currently there are 46 states (and the District of Columbia) that have data breach notification statutes. The hodgepodge of state notification laws creates uncertainty, which spurs the proposal of federal legislation to clear up the differences and create a national standard. The White House's proposal includes a 30-day from discovery of a breach notification requirement, and the Federal IT budget recently requested $14 billion for cybersecurity. In addition to the notification requirement, the White House will also unveil a "Consumer Bill of Rights" and will support the Federal Trade Commission in its development of a resource for victims of identity theft.

Many of the state data breach notification laws have been passed in the last few years. By the very nature of the laws' recent establishment and unseasoned enforcement, consumers and business owners are still uncertain as to how the laws work and whether they provide adequate protection. Initially there is considerable bipartisan support in Congress for federal cybersecurity regulations. In fact, several bills have been proposed in past legislative sessions. Regardless of whether Congress continues to make cybersecurity a top policy issue for the current legislative session, the safety of confidential information has never been more of a nationwide concern.

By way of example, in 2014 Florida passed its version of data breach notification laws called the Florida Information Protection Act ("FIPA"). FIPA requires that all companies take reasonable measures to protect personal data, such as encrypting it or removing personally identifiable information. Any data breach that affects 500 or more individuals must be reported to the Florida Department of Legal Affairs within 30 days, and companies must also supply forensic reports and their internal breach policies. In many circumstances, individuals whose information is compromised must also be notified by the company within 30 days. If the breach involves more than 1,000 individuals, all credit reporting agencies must be informed. There are serious consequences for failure to comply with the new rules, as companies may face fines of up to $500,000.

It is likely that both the federal government and the states that have recently implemented data breach notification laws will look to states such as California (2002), where laws have been in place for a considerable length of time as a model for effectiveness and enforcement. In light of the varying state regulations, the concept of a uniform federal law governing data breach notification and enforcement is sensible. If written with careful consideration, a federal standard could remedy the current pitfalls of the state-by-state approach, which is especially cumbersome from a compliance standpoint for nationwide businesses. Regardless, this area of the law is building momentum out of necessity and can no longer be overlooked by consumers, business owners and legal practitioners.

The Data Breach Team is led by attorney Michael S. Taaffe, who along with his team in the Sarasota office, have dealt with data breach legal issues in the financial services and other industries for many years. Other attorneys on the Team include Scott A. La Porta; Michael D. Bressan; Jarrod J. Malone; Douglas A. Cherry; David L. Wyant Jr.; and Ryan S. Nichols in the Sarasota office; Thomas P. Dillon and Peter R. Silverman in Toledo; Jaime Austrich; Erin Smith Aebel; Ernest J. Marquart; J. Todd Timmerman; and Rachel B. Goodman in Tampa; David H. Conaway, Jeffrey S. Bernard; Joseph J. Santaniello; and Steven A. Meckler in Charlotte; as well as David F. Axelrod in Columbus. The team includes the following attorney banking representatives to provide additional support to bank clients: Malcolm J. Pitchford (Sarasota); Martin D. Werner (Toledo); and W. Kent Ihrig (Tampa). The Shumaker Data Breach Team can assist in all aspects of data breach incidents including the prevention of data breaches as well as the ramifications after a breach.

For more information, contact Mike Taaffe at mtaaffe@slk-law.com or 941.364.2720.

Ohio Brightens its Bright-Line Test

Ohio has a bright-line test (the "Test") for determining when an individual is domiciled in Ohio for purposes of Ohio's income tax. A bright-line test is an objective test, which is one based upon factual criteria, rather than a subjective test, which is one based upon an individual's subjective intent. As more fully described below, Ohio recently amended its law to allow an individual to spend an additional 30 days in Ohio (from 182 to 212 contact periods) without potentially being subject to the Ohio income tax.

By David J. Rectenwald

1. **Contact Periods.** The Test starts with the number of "contact periods" an individual has in Ohio during a tax year. The concept of "contact periods" is different than the number of days or nights spent in Ohio. Ohio law provides that an individual has one contact period in Ohio if:

   (a) The individual is away overnight from the individual's "abode" located outside of Ohio; and

   (b) While away overnight from that abode, such individual spends some portion (however minimal) of two consecutive days in Ohio.

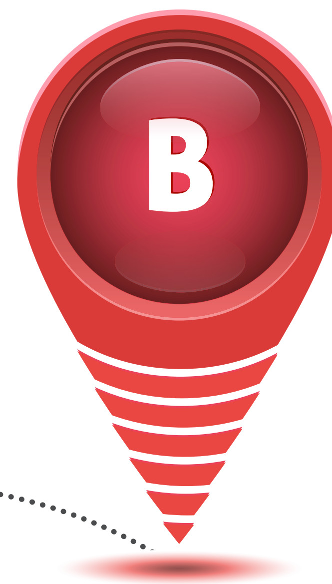
2. **Critical Number.** Ohio law establishes one specific number of contact periods that is critical to the Test. Prior to 2015, that number was 182. Starting in 2015, that number was increased to 212. As more fully described below, this critical number determines how difficult it will be for an individual to prove that he or she was not domiciled in Ohio for income tax purposes in any particular tax year. If the individual has 212 or less contact periods in any given year, then the burden of proof will be fairly easy. If the individual has more than 212 contact periods, then the burden of proof will be much more difficult.

3. **Irrebuttable Presumption.** The Test purports to provide an irrebuttable presumption to any individual who files an Affidavit of Non-Residency (the "Affidavit") by May 31st of the following year verifying that the individual was "not domiciled in Ohio" and has had an abode located outside of Ohio for the entire year. Only those individuals who have fewer than 213 contact periods during the tax year can file the Affidavit. However, it is very unclear how this presumption applies. Specifically, it is not clear what is meant by the statement that each individual makes in the Affidavit that he or she "was not domiciled in Ohio." Is an individual not domiciled in Ohio if he or she has 212 or fewer contact periods, or is an individual not domiciled in Ohio only if the individual is able to prove (by a preponderance of the evidence) that he or she has more contacts in another state than he or she has in Ohio. This exact issue is currently being litigated in the Ohio Supreme Court case of *Cunningham v. Testa*, 138 Ohio St.3d 1476, 2014-Ohio-1765, and a decision is due out later this year. Until then, every individual should assume that the more onerous interpretation applies and that changing those domicile factors described below to another state is required to prove that he or she "was not domiciled in Ohio."

4. **Rebuttable Presumptions.** The Test creates certain rebuttable presumptions that clearly apply to those individuals who do not file an Affidavit. The *Cunningham* decision will determine if they also apply to those individuals who have filed an Affidavit. If they do, then an individual will only obtain an irrebuttable presumption if the individual can rebut the presumption against him or her. Having to rebut a presumption in order to obtain an irrebuttable presumption is indeed a very strange and nonsensical way to structure an irrebuttable presumption, which is exactly what the Cunninghams are arguing in their case. An individual who has fewer than 213 contact periods in any given year is presumed to be domiciled in Ohio unless the individual can prove by a preponderance of the evidence that he or she is not domiciled in Ohio. An individual who has more than 212 contact periods in any given year is also presumed to be domiciled in Ohio unless the individual can prove by clear and convincing evidence that he or she is not domiciled in Ohio. The preponderance standard is generally considered to be a 51% test, while a clear and convincing standard is much tougher to quantify. It can vary from court to court, but it is roughly equal to a 75% test. Thus, an individual can satisfy the "preponderance" test by proving that a majority of the evidence supports such individual being domiciled in another state. An individual can satisfy the "clear and convincing" standard only by showing that about 75% of all of the evidence supports such individual being domiciled in another state. Therefore, it is significantly easier to satisfy the preponderance standard than it is the clear and convincing standard.

5. **Domicile Factors.** Ohio Administrative Code Section 5703-7-16(A)-(D) (the "Regulation") contains a laundry list of factors that the State will and will not examine when analyzing a person's domicile. The factors to be ignored include the location of certain professionals or entities used by or affiliated with the individual or the individual's spouse, such as their doctors, lawyers, accountants, bankers, insurance companies, charities, trustees and other fiduciaries, the location of their friends and family, or the recitation of domicile in any of their estate planning documents. The Regulation contains a very short list of factors that the State will consider. The State will consider the individual's number of contact periods for the year, the activities of the individual in the prior years and any other factors that the State deems relevant. According to Matthew Dodovich, Chief Legal Counsel for the Ohio Income Tax Division, the "other relevant factors" includes whether an individual has retained an Ohio residence, maintained the Ohio homestead exemption, retained an Ohio driver's license, remained registered to vote in Ohio and retained any business in Ohio. Thus, an individual should focus on these factors when moving his or her domicile out of Ohio.

6. **Audit of Contact Periods.** If the State challenges the number of contact periods that an individual claims to have during a taxable year, then the individual bears the burden of proof to verify such number by a preponderance of the evidence. Such person is presumed to have a contact period in Ohio for any period in which the individual does not prove by a preponderance of the evidence that the individual has no such contact period. The Regulation contains a laundry list of writings and other evidence that the State will consider in an audit of contact periods. These include any evidence that shows where the person was in any particular day, including personal diaries, credit card receipts, utility bills and other records "tending to show the physical



whereabouts of the individual." In practice, an individual's cell phone records are very strong evidence of the individual's physical presence and are often subpoenaed by the State.

7. **Transition Year.** The Test specifically does not apply during the year in which the individual changes his or her domicile. Such year is sometimes referred to as the "transition year." In the transition year, an individual is taxed as a resident of Ohio until the date of the domicile change. The individual is then taxed as a non-resident after such date. Thus, an individual who elects to change his or her domicile on November 1st of a year is taxed as an Ohio resident for the first 10 months and taxed as a non-resident for the last 2 months, even though such individual had more than 212 contact periods in Ohio during such year.

8. **Audit Triggers.** Mr. Dodovich has indicated to me that the filing of the Affidavit does not by itself trigger any audits. He indicated that the two primary audit triggers are:

   (a) If an individual has a pattern of filing Ohio income tax returns and then suddenly stops. It is an even bigger red flag if the individual later starts filing Ohio returns again.

   (b) If an individual files a nonresident Ohio return reporting Ohio-sourced income, particularly if the individual previously filed Ohio resident returns.

9. **Tips.** Set forth below is the list of tips based on all of this information and on my discussions with Mr. Dodovich:

   (a) Keep a Diary. By far the most persuasive evidence in establishing the number of contact periods is a diary of physical presence. It is extremely important to maintain this diary on a contemporaneous basis. It is very difficult to try to establish contact periods months or years after the year in question.

   (b) Use a Computer Diary. By far the most persuasive type of diary is one that is maintained on a computer software program such as Google Calendar or Microsoft Outlook.

   (c) Consider Filing an Affidavit. Many individuals who claim that they are not domiciled in Ohio have to make a tough decision annually on whether to file an Affidavit. The advisability of such a filing will depend largely on how the Ohio Supreme Court rules in *Cunningham*. This is a very complicated and important issue. Such individuals should talk this issue through with a qualified tax counsel.

   (d) Retain Evidence. A person should retain all evidence of domicile until the statute of limitations has run. The statute for Ohio income taxation is 4 years if an Ohio income tax return has been filed, or 10 years if one has not. Note that the State's position is that the Affidavit is not a tax return, so that the filing of an Affidavit without an Ohio income tax return does not start the statute of limitations.

   (e) Arrange Ties. Any individual seeking to become domiciled outside of Ohio should minimize his or her ties with Ohio and maximize his or her ties with another state. Voter registration and driver's license should be changed to the desired state of domicile. The number of contact periods in Ohio should stay below 213. The Ohio homestead should be released and any homestead available in the desired state of domicile should be obtained. Significant additional contacts should be established in the desired state of domicile, including those described above.

CONCLUSION

The increase in the number of contact periods under the Test from 182 to 212 will give many individuals with dual residences the opportunity to avoid Ohio income tax by changing their domiciles to another state. It will also give many other individuals who have already made the change significantly greater flexibility in spending time in Ohio. Nevertheless, for many other individuals the decision to convert their Ohio domicile to another state is an extremely difficult one, especially now when the core of the Test is in limbo and in the hands of the Ohio Supreme Court. The failure either to make the right decision or to make the conversion properly could result in a costly assessment of interest and penalties on top of years of unpaid Ohio income tax. The entire matter should be thought through carefully with the advice and assistance of an experienced tax advisor, and careful and persistent attention to detailed compliance should thereafter be maintained. If you would like to review your specific situation with me, please do not hesitate to contact me.

For more information, contact David Rectenwald at drectenwald@slk-law.com or 419.321.1407.

An Ounce of Agribusiness Prevention is Worth a Pound of Drinking Water Cure

With lawmakers, lawyers, and the public focused on the relationship between agriculture and drinking water, those in farming, fertilizer, and livestock businesses would be wise to heed Ben Franklin's caution that "an ounce of prevention is worth a pound of cure."

By Kevin P. Braig

Such intense public scrutiny increases risk to agribusiness each year. Under these circumstances, it is prudent for an agribusiness to undertake an attorney-supervised environmental and nutrient management audit of their business and educate itself on new agriculture pollution liability insurance policies that are starting to appear in the marketplace. While there have been many recent episodes of new enforcement initiatives and adverse legislation, two recent developments are likely to have the biggest impact on the future of agribusiness.

...the very first bill that the Ohio Senate introduced in 2015 was the "Clean Lake Erie Act" *(S.B. 1)*, which prohibits application of fertilizer and manure in the western basin of Lake Erie under some weather conditions.

First, there are governmental initiatives. In the aftermath of last summer's algae bloom in Lake Erie that prompted the City of Toledo to issue a three-day ban on drinking the city's water, both state and federal legislators have introduced new legislation that will increase regulation of agribusiness' nutrient management practices.

To demonstrate how seriously the Ohio General Assembly is taking clean water and nutrient management, the very first bill that the Ohio Senate introduced in 2015 was the "Clean Lake Erie Act" *(S.B. 1)*, which prohibits application of fertilizer and manure in the western basin of Lake Erie under some weather conditions. The Ohio Senate quickly passed the measure on February 18, 2015.

At the federal level, Ohio Representative Bob Latta introduced the "Drinking Water Protection Act" *(H.R. 212)*, which would require the U.S. EPA to develop a plan to assess and manage risks associated with

algae blooms. In addition, fellow Ohio Representative Marcy Kaptur introduced the "Safe and Secure Drinking Water Act of 2015" *(H.R. 243)*, which would require U.S. EPA to determine what level of microcystins in drinking water could be considered safe. Ohio Senators Sherrod Brown and Robert Portman also introduced drinking water legislation in the U.S. Senate.

The second, more serious concern, is the decision of a federal court in Washington, *Community Association for the Restoration of the Environment v. Cow Palace, LLC*. In this case, the court held that discharges from a dairy's liquid manure lagoons and application of manure to fields, which resulted in nitrate contamination of groundwater, constituted an imminent and substantial endangerment to local drinking water wells.

What is remarkable about the *Cow Palace* decision is that the court applied federal solid and hazardous waste law to an agricultural problem, which previously had been considered to be outside the coverage of these federal laws. Using the new application of these laws to agriculture, federal and state enforcement officials and environmental groups may attempt to force significant change to farming practices and subject farms to monetary penalties that until now have been limited to mostly the chemical industry.

In reaching its decision in *Cow Palace*, the court found the dairy did an inadequate job of adhering to its nutrient management plan and that the over-application of manure constituted "discarding solid waste." The plaintiffs have petitioned the court to order the dairy to line its lagoons and to provide drinking water to residents on well water within a three-mile radius of the dairy.

Recommendations:

To protect itself from the future, an agribusiness should consider conducting an attorney-supervised environmental and nutrient management audit or acquiring agriculture pollution liability insurance, explained below:.

1. Environmental and Nutrient Management Audit.

Twenty-eight states have enacted some form of environmental audit privilege law that protects from disclosure pro-active self-investigation of operations to insure compliance with nutrient management plans and other applicable environmental laws, rules and regulations. Ohio's audit privilege law is contained in section 3745.71 of the Ohio Revised Code. By undertaking an attorney-supervised environmental and nutrient management audit, an agribusiness can verify that its operations are in compliance with its nutrient management plan and applicable environmental laws. In the event the agribusiness determines that operations depart from either, the agribusiness can implement remedial compliance measures to avoid or minimize enforcement costs or civil liability.

2. Agriculture Pollution Liability Insurance.

Because all comprehensive general liability insurance policies contain the absolute pollution exclusion, claims that are based on groundwater contamination allegedly caused by agribusiness are highly unlikely to be covered. However, some insurance companies are now beginning to offer specialty agriculture pollution liability insurance. In general, this expanded coverage offers protection to an agribusiness that processes and distributes agricultural products for sudden and accidental as well as gradual environmental liabilities, including bodily injury, property damage, and remediation costs arising out of conditions migrating from a covered location. If you consider purchasing an agriculture pollution liability policy, make sure to carefully review the operations and materials and substances that are covered and the exclusions which preclude coverage.

For more information, contact Kevin Braig at kbraig@slk-law.com or 614.628.4433.

The New North Carolina LLC Act as Estate Planning Tool

On January 1, 2014, the North Carolina General Assembly repealed Chapter 57C of the North Carolina General Statutes and replaced it with Chapter 57D, which became the new North Carolina Limited Liability Company Act (the "New LLC Act"). *See* N.C. Session Law 2013-57. This New LLC Act provides both corporate and estate planning attorneys with a great opportunity to review and revise the terms of their client's operating agreements.

By Joshua M. Hayes

Although the New LLC Act (as well as the previous version of LLC Act) ostensibly limits the scope of an LLC to engagement in "any lawful business," *see* N.C. Gen. Stat. § 57D-2-01(c), the New LLC Act defines the term "business" (other than in the context of a foreign LLC transacting business in North Carolina) as "[a]ny lawful, trade, investment or *other purpose or activity*, whether or not conducted or undertaken for profit." N.C. Gen. Stat. § 57D-21-03(3) (emphasis added). As such, North Carolina LLCs are not limited to profit-making enterprises, but may be used for nonprofit and socially beneficial enterprises as well. Therefore, LLCs can be used in lieu of a trust for cost-sharing purposes or to jointly own property or to achieve any other legal objective, including estate planning.

A major benefit of utilizing limited liability companies for estate planning purposes is their inherent flexibility.

A major benefit of utilizing limited liability companies for estate planning purposes is their inherent flexibility. The stated intent of the North Carolina General Assembly in passing the New LLC Act was to grant parties the power to customize and specify the terms of their operating agreements as "they determine to be appropriate with minimum prescribed formalities or constraints." N.C. Gen. Stat. § 57D-10-01(b). Estate planning attorneys should therefore be mindful of ways that an LLC operating agreement could achieve a client's particular objectives, as the flexibility granted by these freedom of contract principles most likely means that a peculiar or unusual term contained in an operating agreement will not be found to violate the New LLC Act or common law.

Among the changes to the New LLC Act is a clear delineation between the different types of LLC ownership

interests. For example, the New LLC Act defines an "economic interest owner" as possessing rights in the "capital, income, losses, credits, and other economic rights and interests of the LLC," but is not a member of the LLC and so does not have non-economic rights related to LLC governance provided to members under the operating agreement or default provisions of the New LLC Act. *See* N.C. Gen. Stat. § 57D-1-03(10), (11). Conversely, a member of an LLC would generally have both economic governance rights in that LLC (subject to potential particularized modification and/or divestment of some of these rights as specified by the parties in the operating agreement).

Understanding the difference between an economic interest owner and a membership interest is very important for an estate planning client. For example, it may be preferable to clearly and precisely define the rules for a desired membership arrangement in the operating agreement by defining or limiting voting, information and dispute rights of members, rather than outright elimination of these rights through economic interest status, which would provide the economic interest owner with none of these rights of governance. *See* Warren P. Kean and Edward W. Griggs, *Estate Planning with the New North Carolina LLC Act,* North Carolina Bar Association, at IV-C-6, (July 2014).

One area where limited liability company law can be useful in the estate planning context is in the creation and maintenance of trusts. Revocable and irrevocable trusts may be interest owners of LLCs. Trustees of revocable and irrevocable trusts can be appointed as managers and other company officials of LLCs. As a result, there are several important issues to consider when incorporating LLCs in estate planning involving trusts, including: (1) the capacity or death of a member or company official, (2) the obligations and duties of the various constituencies of the LLC, (3) the effect that changes in the trustees or beneficiaries of a trust that are members or company officials of an LLC may have on the trust's status as a member or company official, (4) the ability or inability of interest owners to transfer their ownership interests and other liquidity issues, (5) whether to provide for permitted transferees, and (6) the economic and governance/management and information rights and other interests of interest owners and their assignees, and the circumstances under which those rights may be lost or compromised. *See* Kean & Griggs, *supra*, at IV-C-21.

For clients interested in retaining control over the investment decisions concerning trust assets, limited liability companies can provide a means through which to bifurcate a trustee's more traditional accounting, reporting, and distribution duties from its investment obligations. A properly drafted operating agreement could allow for a client to maintain control over a trust's investments by funding the trust with ownership interests in LLCs that vest control over the management of the assets in individuals or entities other than the trustee of the trust. This would allow for a client to maintain a degree of control over a trust's investments while still retaining the planning benefits a trust allows for, such as providing for alternative beneficiaries. *Id*.

Estate planning attorneys must understand how provisions within an operating agreement will affect both the other provisions within the operating agreement itself, as well as their effect on related estate planning instruments, such as trusts, and identify any issues that need to be addressed regarding the client's estate planning strategy. For example, estate planning attorneys must be aware of how a simple transfer of an ownership interest in an LLC to the owner's revocable trust may not be permitted under the operating agreement and may thereby trigger an unintended buy/sell procedure, or how a deceased member's unsatisfied capital call can create a need for the LLC to take action pursuant to Article 19 of Chapter 28A of the North Carolina General Statutes regarding the presentation of creditor's claims against the decedent's estate. Specifying processes and procedures within the operating agreement that address these and other issues *before* an estate plan is implemented can mitigate the costs associated with addressing these issues when they invariably arise.

In summary, the New LLC Act makes several changes to North Carolina limited liability company law, including differentiating between LLC membership interests and LLC economic interests. These and other changes to the New LLC Act can affect estate planning strategies and asset management, especially when a trust is funded with ownership interests in an LLC or where a trustee has been appointed to a managerial position in an LLC. The New LLC Act can provide a flexible alternative to more traditional estate planning instruments, though practitioners must be aware of the ways in which limited liability company law interacts with the law of trusts and successions and work to mitigate and prevent the issues that may arise from these interactions.

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ESTATE OF ELKINS v. COMMISSIONER OF INTERNAL REVENUE:

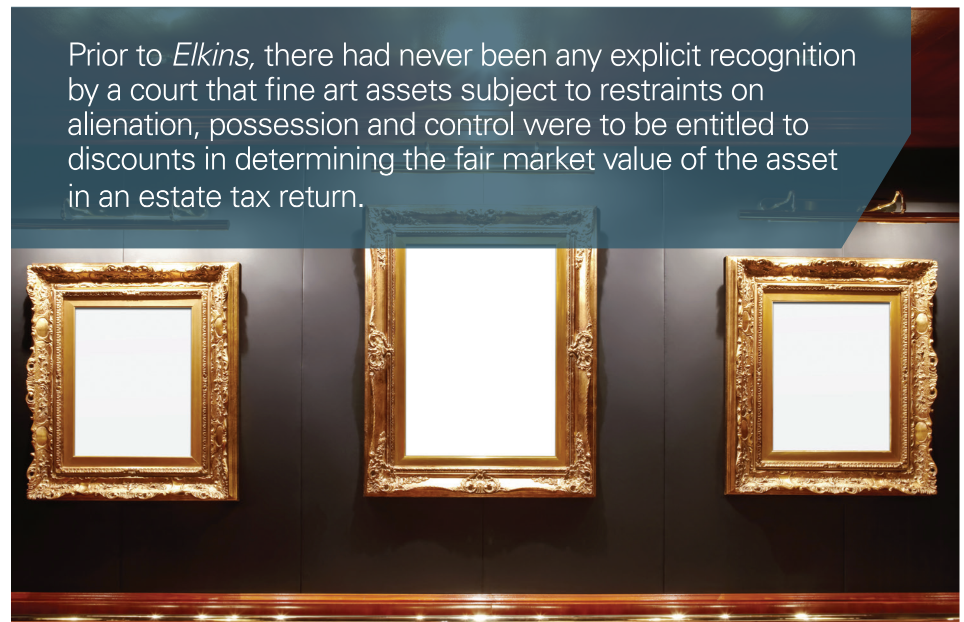
Cautionary Tale and Gem

In the eternal game of cat and mouse between the taxpayer and the Internal Revenue Service (the "Service"), the case of *Estate of James A. Elkins, Jr. v. Commissioner of Internal Revenue*, 767 F3d 443 (2014), represents a "cautionary tale" for the Service and a "gem" for the taxpayer.

I. The Facts

Over the course of a lifetime, James A. Elkins, Jr., the son of the founding member of the venerable Houston based law firm of Vinson & Elkins, and his wife amassed a significant and very valuable art collection consisting of works by many of the giants of modern art. Commencing in the 1990s, Mr. Elkins and his wife, focusing on 64 of the more valuable works from their collection (hereafter the "Collection"), began to consider the manner in which the Collection could be most efficiently transferred to their children to meet their testamentary wishes as well as to minimize the value of their estate. Presciently guided by counsel at his father's law firm, Mr. Elkins and his wife set out to fractionalize the ownership of the Collection in a manner which met family objectives as to the management of the Collection and would result in favorable valuation treatment under the estate tax by allowing the estate to claim a discount from fair market value based on the fact that the Collection was owned as a fractional interest. Inasmuch as all family members deeply cared about the Collection and wanted to share ownership of it, Mr. and Mrs. Elkins, and after Mrs. Elkins' death, Mr. Elkins, engaged in a series of transactions, described in *Elkins*, which resulted in the Collection being jointly owned in fractional interests by Mr. Elkins and his children after the death of Mrs. Elkins.

By Moses Luski



> Prior to *Elkins*, there had never been any explicit recognition by a court that fine art assets subject to restraints on alienation, possession and control were to be entitled to discounts in determining the fair market value of the asset in an estate tax return.

After the death of Mrs. Elkins, the family voluntarily put a number of controls in their fractional ownership interests in the Collection as indicated by this excerpt from *Elkins:*

> From time to time following the death of his wife, Decedent and his children voluntarily subjected their respective interests in the works of art to various restraints on possession, partition, and alienation. For example, Decedent's three children leased their combined 50 percent interests in two items of [the Collection] to Decedent thereby ensuring his uninterrupted possession of those two works. That lease, which was still in effect at Decedent's death, specified, *inter alia*, that no

> co-owner could dispose of his or her interest in a leased work unless joined by all co-owners. The lease also provided that none could transfer or assign his or her "rights, duties and obligations" under the lease without the prior consent of all.
>
> Similarly, Decedent and his children encumbered 61 items of [the Collection] with a "Cotenants Agreement." Among other things, it spelled out each co-owner's right of possession for a specific number of days during any 12 month period. More pertinent to this appeal, that agreement prohibited the sale of an interest in any work by a co-owner without the prior consent of all. The one piece in [the Collection] that had not been subjected to the children's lease to Decedent was eventually added to the list of works covered by the Cotenants Agreement.

Estate of James A. Elkins, Jr. v. Commissioner of Internal Revenue, 767 F3d 443, 447–48 (2014).

Several key factors should be noted in the above described sequence of events: (a) the fractionalization of ownership of the Collection took place well before the death of either Mr. or Mrs. Elkins; (b) great care was taken to impose legally binding restrictions on the alienation, possession, and control of the fractional interests, and no evidence was adduced that the family had failed to abide by the agreement; (c) the fractionalization was driven by "natural causes" and necessity, i.e. the grim reality that eventually loved ones pass away and the control and possession of fractional interests in property that they leave must be rationalized among an entire family. The estate planning insight was to take a plain vanilla tenancy in common of the fractional interests and layer it with numerous restraints on alienation, possession, and control.

Upon filing Mr. Elkins' estate tax, the estate valued Mr. Elkins' fractional interest in the Collection as approximately $12.2 million, which reflected a 44.75% fractional discount from fair market value. The appraisal of the Collection was performed by Sotheby's and the discount valuation was calculated by Deloitte, LLP. (*Id.* at 445, fn. 1.)

After review of Mr. Elkins' estate tax return, the Service denied the estate's discount valuation of 44.75% and assessed an estate tax deficiency of $9,068,266.00, which was based on the undiscounted fair market value of the Collection, which was $18,500,000.00. (*Id.* at 447.) This is where the Service's cautionary tale begins. It is my contention that, in *Elkins*, the Service mismanaged its strategy as to how to protect its position that fine art assets were not entitled to fractional interest discounts as well as its tactics with respect to the most effective way to try the deficiency case.

II. Before The Tax Court "A Cautionary Tale"

A. Strategy

Prior to *Elkins*, there had never been any explicit recognition by a court that fine art assets subject to restraints on alienation, possession and control were to be entitled to discounts in determining the fair market value of the asset in an estate tax return. At most, cases like *Estate of Scull v. Commissioner of Internal Revenue*, 67 T.C.M. (CCH) 2953 (1994) had awarded minimal discounts to take into account an extraneous factor, such as pending divorce litigation. A potential interpretation of *Scull* was that art assets were never sold in partial interests and thus had to be valued at par regardless of how they were held. *See Estate of Scull v. Commissioner of Internal Revenue*, 67 T.C.M. (CCH) 2953, at *19–*21 (1994); *see also*, *Stone v. United States*, 100 A.F.T.R. 2d 2007-5512 (2007). This was a major strategic advantage for the Service, but it should have been loath to test it in court. The argument that fine art must always be valued at par was suspect to begin with, as there is nothing in the law of estate taxation that would lead one to believe that fine art should be treated differently from any other tangible asset. Further, the notion that fine art is an asset that is never bought or sold in fractional interests is losing currency given the development of fine art as an "asset class" and the evolution of this concept in the art market. Strategically, then, there was a significant risk that a court today might not go along with the Service's "no discount" position. Thus, the strategic advantage held by the Service was the lack of clear cut legal authority and this uncertainty should have been used by the Service to enhance its bargaining position to negotiate a suitable discount. So long as the uncertainty in the law persisted and *Scull* remained unchallenged, the Service could presumably have a stronger negotiating position with respect to "fine arts" valuation issues. Once the service could no longer rely on *Scull* as precedent, its negotiating position would be diminished. Thus, it was poor strategy to let this case go to trial. Compounding the strategic risk was the fact that the Service's opponent in this case, the Elkins Estate (the "Elkins Estate"), had deep pockets and sophisticated counsel. Even if the Service was looking for a test case to solidify its "no discount"

position, this was not the right case. Notwithstanding the foregoing, the case went to trial, which leads us to the tactics employed at the trial.

B. Tactics

The mantra of the effective trial lawyer corresponds to the Boy Scout motto: "Be Prepared." Actually, a better exposition of this mantra is "Be Over-Prepared." The trial lawyer should be prepared for every possible contingency and should protect his record on appeal. Once the Service was put to trial, it inexplicably failed to aggressively litigate the issue of valuation or protect the record for appeal with respect to the value of the Collection by presenting its own evidence of valuation. Quite possibly, the Service was intractably invested in the notion that there was no market for fractional interests of fine art. Also, the Service may have felt that the "control" provisions of the Cotenants Agreement and lease prepared by Mr. Elkins was invalidated by the provisions of Section 2703(a)(2) of the Internal Revenue Code ("IRC"), which under certain circumstances, ignores "control" provisions imposed on estate assets. Whatever the reasoning, the Service waged everything on the argument that as a matter of law, the Elkins Estate was not entitled to a discount on the fair market value of the Collection.

At trial, the Elkins Estate presented extensive expert testimony as to what the discounted value of the Collection should be. *See Estate of James A. Elkins, Jr.*, 767 F.3d at 451–52. The testimony was presented in terms of specific economic analysis of the value of fine art assets, analysis of the art market, and legal analysis of the law of partition. *See id.* It was a substantial showing.

Against this evidentiary showing, the Service merely argued that as a matter of law, there was no market for fractional interests in fine arts and that the proper measure of such fractional interests is the fair market value after all fractional owners agree to sell. Additionally, the Service raised technical arguments based on Section 2703 of the IRC, which are beyond the scope of this paper. Incredibly, the Service presented no evidence of valuation other than the fair market value of the fine arts in question, relying solely on its legal theory. The sole expert presented by the Service stated that sales of fractional interests of fine arts were rare, but could not rule out that such sales never occurred. *See id*. at 448–49. There was equivocal testimony produced regarding the personal motivation of the children of Mr. Elkins who were cotenants with the deceased father. The testimony indicated the children were emotionally attached to the art and would not sell it, but would only pay a "fair" price for any minority interest. *See id.* at 451. The relevancy of this testimony regarding motivation could be questioned since the fair market value test used to value assets for purposes of determining the value of a decedent's estate is not supposed

to factor personal motivation but consider the value that a hypothetical buyer and seller would assign to an asset.

The tactics used by the Elkins Estate to defend its estate tax return were overwhelming analysis and proof of fair market value. The tactics used by the Service to defend its assessment were to rely on a legal argument and focus on the motivation of the Elkins children. In my view, the tactics used by the Elkins Estate were consistent with the best practices of a trial attorney-focused, extensive and thorough with overwhelming proof and attention to preserving an excellent appellate record. The tactics used by the Service were inexplicably lacking with no consideration to protecting the appellate record on the factual issue of the value of the Collection. As a result, on appeal the only evidence of valuation was that presented by the Elkins Estate.

The flawed tactics of the Service did not result in an adverse outcome for it at the Tax Court level. *See Estate of Elkins v. C.I.R.,* 140 T.C. 86 (2013) *aff'd in part, rev'd in part,* No. 13-60472, 2014 WL 4548527 (5th Cir. Sept. 15, 2014). The Tax Court, stressing that Mr. Elkins' children were motivated to protect their fractional interest in the Collection held that the value of the Collection merited a nominal discount from fair market value of 10%. *See id.* at 135. The Tax Court ruling, however, presented the Service with a significant strategic defeat which would prove its undoing on appeal. The Tax Court held that there was no prohibition in the tax code which would prevent a discount from fair market value for fine art owned in fractional interests. *See id.* at 126. The inevitable appeal which followed would prove the strength of the Elkins Estate's strategic and tactical choices and, conversely, of the Service's poor judgment.

III. Before the Fifth Circuit Court of Appeals

The Gem

In the inevitable appeal to the Fifth Circuit Court of Appeals (the "Fifth Circuit") by the Elkins Estate of the Tax Court's decision, the poor strategic and tactical choices made by the Service produced a gem for the taxpayers.

Before the Fifth Circuit, the strategic and tactical weaknesses in the Service's case were exposed as the Court made short shrift of the Services arguments as follows:

1. The Court clearly held that there was absolutely no prohibition in the law against discounting the value of fractional interests in fine art provided that adequate evidence of economic analysis justifying the discount was presented. The *Scull* and *Stone* cases were distinguished as being merely cases where the taxpayer had failed to submit sufficient economic analysis to justify value discounts for fractional interests in art and not cases holding that discounts for fractional interests in art were forbidden. *See Estate of James A. Elkins, Jr.*, 767 F.3d at 450.

2. The Court held that its review of the value of the Collection for estate tax purposes was a mixed question of fact and law which the Court could review de novo on appeal. *See id.* at 449. This was not good news for the Service because it had failed to present any valuation evidence at trial. The Court then held that the very detailed evidentiary showing of the Elkins Estate, which consisted of legal analysis of partition of jointly held assets as well as specific economic analysis of the value of fractional interests of fine art, justified value discounts in excess of the 44% originally propounded by the Elkins Estate and that the trial court clearly erred in ignoring this evidence which the Court found credible and sufficient. *See id.* at 452–453. The Court further held that the trial court had improperly focused on the personal motivations of the heirs of Mr. Elkins arriving at its 10% discount valuation, stating that such reasoning departed from the classic definition of fair market value, which is based on a hypothetical buyer and seller. *Id.* Finally, the Court held that since the evidentiary showing of the Elkins Estate was adequate and the Service had failed to present any evidence of value, it would accept the value presented by Elkins Estate, which justified discounts ranging from 50% to 80% of fair market value. *Id.* Since this issue was a mixed question of fact and law, according to the Court, there was no need to remand to the trial court. Thus, the failure of the Service to present any evidence of value was fatal to its case. 767 F3d at 450-452.

3. Significantly, for purposes of future cases, which may rely on the precedent of *Elkins*, one of the experts utilized by the Elkins Estate was an economic analyst who had never previously appraised fine art. However, the analysis of this expert was specifically geared to

the characteristics of a fine art asset. The Court accepted this without comment. This implies that fine art is to be treated just like any asset, which may sometimes be valued at par or at discount depending on the circumstances. Also, the fact that the agreements relating to the fine arts assets were between family members did not affect the valuation discounts. This implies that so long as there is a sound purpose for the transaction, family planning goals relating to fine art assets will be accepted.

IV. Conclusion

The Service's mishandling of its case in *Elkins* has now resulted in a clear precedent by a Federal Circuit Court of Appeals allowing substantial discounts from fair market value for fractional interests in fine arts assets for purposes of calculating a decedent's gross estate. *Elkins* is a diamond in the rough, which savvy taxpayers can polish to create discounts in fractional interests of fine arts assets in the valuing of a decedent's estate. The planning involved to justify such a discount is not a slam dunk. Careful attention must be devoted to the agreements creating the fractional structures, which agreements must be complied with, and there must be a substantive economic justification for the discount in value. There should also appear to be a planning motivation for the fractional structure other than obtaining a discounted value.

Had the Service negotiated with the Elkins Estate prior to or during litigation and relented on its inflexible position of zero discount, it could have avoided the damaging precedent established by *Elkins* and could have continued to rely on the *Scull* and *Stone* cases to assert that fine arts assets were entitled to little or no discount from fair market when valuing a decedent's estate. No more, this train has left the station.

For more information, contact Moses Luski at mluski@slk-law.com or 704.945.2161.

welcome

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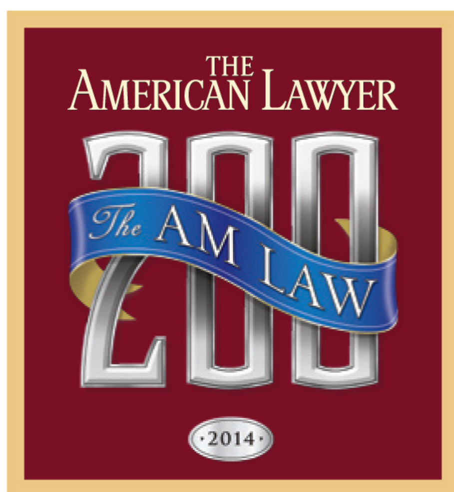
Announcing a new Shumaker Blog: the *Shumaker Sports Report*

Up to the minute reports dominate the sports world. The stories that are reported in the course of a day many times are the catalyst for policy changes, culture shifts in sports organizations, and legal action impacting individual teams, athletes, coaches, and executives. The *Shumaker Sports Report* provides an in depth look at the most important and current topics that affect sports professionals. All sports, all leagues, and all issues relating to the sports world are discussed providing in depth analysis of the most interesting and relevant topics in sports.

Shumaker Sports Report is authored by attorneys **Bennett Speyer**, **Dana Drew Shaw** and **Seth Traub**. Be sure to visit the blog at http://shumakersportsreport.com/ and sign-up to receive email notifications to stay current on what's trending in the sports world. You can also follow our sports attorneys on Twitter @ShumakerSports.

Shumaker is an Am Law 200 and *National Law Journal* Top 350 firm.



Diversity at Shumaker

Shumaker is proud to be INVOLVED and actively participates in organizations that support diversity initiatives in our communities.

Shumaker participated in the Stetson University College of Law's "Inclusion Summit: Developing Cultural Competence" on February 6, 2015. This premier one-day event featured national and regional thought leaders who shared best practices in inclusion and cultural competence for individuals and organizations.

Tampa

- George Edgecomb Bar Association's 2015 Scholarship banquet, April 27, 2015
- Tampa Museum of Art's "Pride & Passion," May 16, 2015

Toledo

- Toledo Chapter of Jack and Jill of America, Inc. "Jack and Jill Juneteenth 5K Run/Walk," June 20, 2015
- African-American Male Wellness Walk (AAMWW) Initiative's "5K Walk/Run," August 15, 2015

slknews

Erin Aebel received the American Diabetes Stop Diabetes® SHARE Leadership Award. Erin was reappointed to The Florida Bar Health Law Certification Committee and was appointed to the Board of Directors of the St. Petersburg Museum of Fine Arts. Erin spoke to the Tampa Chamber of the Professional Association of Physician Office Managers in March at the University of South Florida and also spoke at Nextech's national seminar for health care providers in February in Orlando, Florida.

Erin Aebel and Ed McGinty spoke to a group of USF physicians at the USF Morsani College of Medicine in February.

Jeni Belt was named "Best Toledoan" by the *Toledo City Paper*.

Steve Berman and Todd Timmerman were guest lecturers at the University of Florida College of Law Advanced Bankruptcy Seminar in March.

Cheri Budzynski was appointed to Ohio State Bar Association's Legal Ethics and Professional Conduct Committee.

Ron Christaldi is the recipient of the Tampa Bay Businesses for Culture & the Arts Individual Impact Award. He was also honored, alongside fellow partner, **Greg Yadley**, as a past president of the organization. Ron also received the prestigious 2015 Board of Trustees Award in recognition of his longstanding service to the AMIkids-Yes program.

Jason Collier, Jennifer Compton, and Dan Strader presented an Employment Law Update in Sarasota in February.

Jack Gillespie has been appointed to the initial Advisory Board of the Ohio Machine Foundation.

Katie Gromlovits received board certification from the North Carolina State Bar Board of Legal Specialization in Trademark Law.

Michele Hintson, Jan Pietruszka, and Brad deBeaubien presented an Employment Law Update in February in Tampa.

Regina Joseph wrote an expanded version of her blog "Are Browsewrap Agreements Enforceable?" which was published in the November 2014 issue of Bloomberg BNA's *Social Media Law & Policy Report.*

Warren Kean has been honored with the Business Law Section Distinguished Service Award by the North Carolina Bar Association. Warren spoke at the 14th Annual North Carolina / South Carolina / Georgia Bar Associations' Tax Section Workshops and also spoke at the University of North Carolina School of Law's J. Nelson Young Tax Institute 2015 in May.

Suzi Marteny hosted a seminar at the "World Intellectual Property Day" at the Charles H. Wright Museum of African American History in Detroit, Michigan in April.

Andrew McIntosh spoke at the Enterprise Florida-Greater Tampa Chamber of Commerce Country Market Brief: Canada in January at the Greater Tampa Chamber offices.

Scott Newsom spoke at The University of Toledo Center for Family & Privately-Held Business in February and shared important updates on the "Play or Pay" portion of the Health Care Act.

Hunter Norton was appointed to The Florida Bar's Twelfth Circuit Judicial Nominating Commission.

Dana Drew Shaw was a panelist at the Sports and Entertainment Law Summit at Valparaiso University School of Law.

Bennett Speyer presented at the Collegiate Sports Summit in Santa Monica, California in April.

Lou Tosi gave a presentation on the USEPA's new Clean Power Plan and Greenhouse Gas Control strategies and their impact on the Electric Power Industry at the AHC Executive Workshop on Carbon Innovation in Phoenix, Arizona in January.

Kristina Wildman gave a presentation on the basics of estate planning to the International Brotherhood of Electrical Workers Local Union No. 8 in April. She also presented to the Toledo Estate Planning Council in February on estate planning and digital assets.

Brian Willis has been elected Vice-Chair of the Citizen Advisory Committee for the Hillsborough County Metropolitan Planning Organization (MPO). Brian was also a panelist at Tampa Bay Startup Week discussing Fostering a Startup and Innovation Ecosystem.

Al Windle presented to the Associated Builders and Contractors, Carolinas Chapter, on "Essential Construction Project Documentation" in April.

Greg Yadley was principal Chair of the 33rd Annual Federal Securities Institute in Miami, Florida, in February. In addition, he made a presentation on "The Importance of Accredited Investors for Small Business Capital Formation."

insights

A Newsletter from Shumaker, Loop & Kendrick, LLP

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Whether it's our commitment to clients, or to our work in the community, involvement lies at the core of everything we do.

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