Ready Capital

Los Angeles lawyer Mark Hiraide analyzes the regulatory regime and impact of the Jumpstart Our Business Startups (JOBS) Act.

Estate Form 8971
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2017 Chapman Law Review Symposium
The Future of the Legal Profession

FRIDAY, FEBRUARY 10, 2017
9 a.m. to 5 p.m. ■ Kennedy Hall, Room 237

SCHEDULE:
- Check-in and Continental Breakfast (9:00 - 9:45 am)
- Panel #1: The Global and Multi-Jurisdictional Practice of Law (10:00 - 11:30 am)
- Luncheon with Keynote Address by Honorable Samuel A. Alito, Jr. (12:00 - 1:30 pm)
- Panel #2: The Future of the Profession (1:30 - 3:00 pm)
- Panel #3: Emerging Areas of Education and Practice (3:15 - 4:45 pm)
- En Banc Reception - Appetizers and Drinks (5:00 - 7:00 pm)

FEATURING A SPECIAL KEYNOTE PRESENTATION BY
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Associate Justice, Supreme Court of the United States

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The Jumpstart Our Business Startups Act provides new ways to conduct public offerings exempt from SEC registration thereby legalizing crowdfunding

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Designation of a partnership representative to handle IRS audits and distinguishing the review year from the adjustment year of the audit are key elements in new partnership audit rules found in the Protecting Americans From Tax Hikes Act
Plus: Earn MCLE credit. MCLE Test No. 263 appears on page 27.

30 Damage Control in the TMZ Era
BY MANNY MEDRANO AND RALPH FRAMMOLINO
Long before the rise of social media, the U.S. Supreme Court decided that attorneys have not only the right but also the obligation to defend their clients in the court of public opinion
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Los Angeles Lawyer December 2016

MAY 2016
It's that time of the year again—time to reflect on the year that is drawing to a close and to ponder what the new year will bring. In the midst of the hustle and bustle of the holidays, perhaps the most satisfying gift that we can give to ourselves is to set aside time to consider the lessons we have learned this year and how we can best use them for growth and motivation in the year ahead.

If we do make the time to reflect, we can take the opportunity to recognize and genuinely appreciate what we have accomplished both personally and professionally and how those accomplishments have benefitted us, our families, clients, and colleagues, in the short term and down the road. It may also give us insight into how we can build on our accomplishments to create greater and more lasting value for ourselves and others.

On a personal level, we can cherish the bonds that we enjoy with our significant other, children, family members, and friends, and strive to strengthen those bonds further in the coming year.

Professionally, we can reinforce the relationships that we have established with our partners, associates, and administrative staff and perhaps foster a more collaborative and collegial work environment. For our clients, we can identify ways to enhance the value of the services that we provide to help solidify those relationships and encourage them to make referrals.

Depending on the focus of our respective practices, our perspectives will vary on what we hope to achieve next year. For example, some may be satisfied by closing more deals than the preceding year or having more wins than losses in their matters. Others may gain greater professional satisfaction by devising a new set of deal terms at the very moment when the parties were at an impasse and about to walk, and those terms convinced the parties to stay the course and finalize the transaction. For a litigator, the same may be attained by finding an overlooked precedent, developing a new argument in a case that otherwise seemed to be going south, or persuading the court to ultimately rule in favor of one's client.

Some of us may find that a sense of accomplishment also can be attained outside a daily practice. One opportunity is serving on a professional board or committee such as those established by the Los Angeles County Bar Association or the State Bar. Speaking at professional seminars is another. Last, but certainly not least, opportunities exist to write articles for Los Angeles Lawyer and other professional journals.

Finally, many of us may find tremendous satisfaction in giving back to our community. This can be accomplished through a variety of means, including contributing financially to LACBA's Counsel for Justice, or volunteering with one of LACBA's projects: Domestic Violence Legal Services, Veterans Legal Services, Immigration Legal Assistance, and AIDS Legal Services. You may also wish to provide financial support to a local nonprofit or serve as a director for an organization advancing a cause of personal interest.

On behalf of the Los Angeles Lawyer Editorial Board and staff, we wish you a joyous holiday season and a new year that exceeds your expectations, both personally and professionally.
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Eli Broad  Philanthropist and Entrepreneur

The Foundation also supports existing nonprofits. How is a grant determination made? Most of what we do concerns things we create ourselves, whether it’s in education, medical research, or the arts. We do support other organizations, but they are opportunities we identify. We don’t accept unsolicited grant applications.

How do you decide where to create or to give? We have three criteria: Will it happen without us? If it is going to happen anyway, we don’t get involved. Is it going to make a difference in 20 years? And are there people who can really make it happen?

What is misunderstood about being a philanthropist? People think that you have a hidden agenda, especially in education. All we want to do is improve student achievement. Some parties think we have a different agenda—to profit from what we are doing. I can tell you unequivocally that we do not make a dime from our philanthropy.

At the Broad Center, the concern is urban education. What is your one wish for LAUSD? LAUSD has to be more cooperative with charter schools.

Cooperate how? LAUSD is not willing to share empty classroom space and it is required by law to do so.

The Broad Institute is the leading genomic medicine institute. Is this the medical approach of the future? We are happy to be involved because it’s going to make a big difference.

The Broad has long lines around the block. Were you surprised by this success? We thought it would be 300,000 per year, but our first-year attendance was nearly triple what we expected.

Admission at The Broad is free, but MOCA charges $2. Why is that? We are able to offer free general admission because we have endowed The Broad. We wanted it to be a gift to the people of Los Angeles. We especially wanted to make it available to young people and diverse visitors from all backgrounds.

We’ve been successful with that.

What is your favorite item at the gift shop? The Collection catalog.

You have a personal art collection with nearly 600 works. What is your favorite piece? Jeff Koon’s Rabbit is one of our favorites. Jeff’s a good friend.

In 2012, your book, The Art of Being Unreasonable: Lessons in Unconventional Thinking, debuted as a New York Times and Wall Street Journal bestseller. What is the most unconventional thing you did? Taking a traditional life insurance company and making it a retirement savings giant, then selling it for $18 billion, which has allowed our family to have more money to make a difference philanthropically.

You are the only person to build two Fortune 500 companies in two different industries—KB Home and SunAmerica. What advice do you give to young business graduates? Read my book, be well-informed, and do a lot of research.

What is the secret to success? The harder you work, the luckier you get.

Kaufman & Broad streamlined the construction process. How? We shortened the construction time from four months to 45 days by prefabricating elements of a home’s construction off-site and delivering to the building site exactly the materials necessary, almost like a model kit.

You are 83 years old and seem to always be on the go. Why? I want to accomplish things. I don’t want to sit around and just do nothing.

You were born in the Bronx, educated in Michigan, and live in California. Where’s home? Los Angeles.

You have been called a man with Midwest candor, such as “the buck stops here.” Do you see yourself that way? I do.

For decades, you were the youngest Michigan resident to attain the credentials of CPA.

What is the perfect day? A day in which I accomplish something and make a difference.

You are the cofounder of the Eli and Edythe Broad Foundation, which focuses on three areas of philanthropy—education, science, and the arts. What are your duties? I’m the leader.

Were you thinking of the human mind, body, and spirit when you decided upon these categories? I haven’t thought of it that way. We’re involved in improving public schools, especially in our hometown of Los Angeles; we’re involved in scientific and medical research, and expanding public access to the arts, as well as The Broad Art Foundation, which serves as a lending library of contemporary art to museums around the world.

Were you thinking of the human mind, body, and spirit when you decided upon these categories? I haven’t thought of it that way. We’re involved in improving public schools, especially in our hometown of Los Angeles; we’re involved in scientific and medical research, and expanding public access to the arts, as well as The Broad Art Foundation, which serves as a lending library of contemporary art to museums around the world.
you consider yourself an overachiever? I push myself pretty hard and I get others to achieve things they didn’t think they could achieve.

Through The Giving Pledge, you and your wife personally committed to give 75 percent of your wealth to charity. Some say you’ve given away enough. What do you say? Give more.

Has technology changed the way you are involved with your philanthropic interests? I use a smart phone and a computer, but I don’t text.

What was your best job? Creating The Eli and Edythe Broad Foundation.

What was your worst job? Selling women’s shoes.

You have said your wife has an eye for art. What characteristic do you most admire in her? She’s very frank, very caring, and has a very different personality than I do.

You are credited with making Disney Hall happen. What is your favorite kind of music? Jazz.

You have been called the father of DTLA. What is the biggest challenge facing our urban community? We have to improve our schools. Every family, regardless of their income or where they live, deserves access to a high-quality school.

Which magazine do you pick up at the doctor’s office? I bring my own papers; I spend two hours reading four papers per day—Los Angeles Times, New York Times, Wall Street Journal, and Financial Times.


What do you do on a three-day weekend? I sit in the sun and go out for dinner with friends. I used to play tennis but I never had the patience for golf.

What is your favorite spectator sport? Football. I record the games, so I don’t have to watch all of the commercials.

What are the three most deplorable conditions in the world? The refugee crisis, terrorism, and hunger.

Who are your two heroes? President Obama and President Truman.

Which one person would you most like to take out for a beer? Bill Clinton.

What would you like written on your tombstone? He made a difference.
Practical Considerations in Starting a Solo Law Practice

WHEN DECIDING WHETHER to start a solo practice, the devil is in the details. An abundance of resources gives 10,000-foot overviews of starting a solo practice—nuanced, seemingly mundane decisions in hanging a shingle often among the most important.

First, however, is the importance of obtaining malpractice insurance. Although not required in California, failure to obtain malpractice insurance can open the door to substantial personal liability. Also, clients must be informed of an attorney’s omission pursuant to California Rules of Professional Conduct, Rule 3-410.

Malpractice insurance varies widely company to company, and a thorough investigation of options and price points should be performed. Some policies “burn down” and provide one maximum amount for coverage, which is allotted to both attorney fees and settlement. Others list the coverage limit to delineate maximum payment for settlement, while legal fees are covered separately (potentially saving hundreds of thousands of dollars).

Policies typically list two numbers: the amount of coverage per claim and the amount of coverage overall. Failure to understand how this might apply may result in surprising and preventable costs.

In applying for insurance, attorneys receive a comprehensive questionnaire about the details of the new practice. Answers to these questions can substantially change the price of the policy. These inquiries range from the method by which the attorney intends to maintain and back up documents to personal business background. The best way to approach answering the questionnaire is to ensure strict adherence to suggested requirements, exercising caution and prudence in the realm of security, technology, and law firm maintenance. It also goes without saying to never mislead or embellish on the application. In fact, if malpractice insurance cannot be factored into the budget, it may not be time to open a practice.

Second, creating a solid business plan in conjunction with an early niche focus can greatly assist the ability to immediately get off the ground. It is much better to make potential clients and referral sources aware of strengths in specific areas of the law, particularly in Los Angeles which has an abundance of lawyers (thus making it more difficult to gain and maintain a competitive advantage). Clients and contemporaries are more likely to refer to an attorney with a defined focus than a general attorney who dabbles in different types of law. Strong branding can provide greater visibility when potential clients have an issue in a specific area. Lack of direction will inhibit business. Simply being a good attorney is not enough.

A third crucial element is the efficient use of technology. The ability to access records and documents at any point in time, whether it be the courtroom or the boardroom, is now a standard part of any practice. It is virtually impossible to stay organized and prepared without some type of digital platform. There are all-inclusive law-specific programs that provide storage, calendaring, and organizational capacities all rolled into one, but for the price-conscious, there are other secure ways to achieve the same end. For instance, Google Business combines document storage, a calendar, and e-mail system that can easily be integrated into a practice. DropBox provides similar services for organizing cloud-based legal documents. Individual programs that can assist with calendaring, legal research, presentations, and other resources often can be used piecemeal in a way that reduces price by eliminating unnecessary bells and whistles. Upgrading systems has become easier thanks to consumer demand—

Strong branding can provide greater visibility when potential clients have an issue in a specific area.

John D. Fowler is an entertainment and business litigator in Beverly Hills, California.

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THE LATEST STEP IN CONGRESS’S effort to mandate the consistent reporting of basis of inherited assets is the Treasury’s issuance of temporary and proposed regulations, providing guidance on the new reporting requirements imposed on personal representatives of decedents’ estates. In 2015, Internal Revenue Code Sections 1014(f) and 6035 became law, requiring a personal representative of an estate to file (new) Form 8971 within 30 days after filing the U.S. estate (and generation-skipping transfer) tax return (estate tax return). Each beneficiary of the estate is to receive a new schedule (Schedule A) specific to that beneficiary, showing the estate tax value (i.e., the new basis) of the assets that beneficiary receives from the estate. The new law prohibits a beneficiary from using a higher basis than that shown on his or her Schedule A for income tax purposes (depreciation and capital gains).

The new law was enacted to stop perceived abuses in basis reporting in which a personal representative reports a low value for an asset on the estate tax return to minimize estate taxes, but the beneficiary reports a basis higher than that value for income tax purposes. The beneficiary’s basis must be the same as that reported on Form 8971.

Form 8971—Information Regarding Beneficiaries Acquiring Property from a Decedent—reports to the IRS the identities of the beneficiaries (including a Social Security number) who receive assets from the estate (other than cash and certain other excluded gifts), and the estate tax values of those assets. This information could be used by the IRS later when a beneficiary takes depreciation deductions or reports capital gain or loss upon sale of an inherited asset.

If a preparer does not comply with the requirements to file Form 8971 and Schedule A, there may be severe penalties. A beneficiary that uses a basis that is inconsistent with the value reported on Form 8971 may also face penalties.

Filing Requirements

In most cases, if an estate tax return is required, a Form 8971 will also be required. Usually, if an estate tax return is required because a decedent’s gross estate (including taxable lifetime gifts) exceeds his or her available estate tax exemption—currently $5,450,000 for United States citizens and residents dying in 2016—the personal representative must file Form 8971. If the decedent was a nonresident alien, the filing requirement applies if the value of his or her U.S. assets exceeds $60,000 at the time of death. If Form 706-A is required to be filed for an estate holding special use valuation property (typically farm or ranch land) either because that property has been disposed of or because its special use has been discontinued, the personal representative is required to file Form 8971. The personal representative must prepare a separate Schedule A for each beneficiary who has received or will receive property from the estate. If the personal representative does not know which assets will be distributed to a beneficiary at the time Form 8971 is due, then all assets that could be distributed to the beneficiary must be listed on that beneficiary’s Schedule A. All Schedules A are to be filed with Form 8971, but each beneficiary is to receive only his or her specific Schedule A—not Form 8971 and not any other beneficiary’s Schedule A.

The assets that are required to be reported on (at least one) Schedule A are all assets that increase the final amount of the estate tax. Since assets passing to a surviving spouse or to a charity do not increase the estate tax if a marital or charitable deduction is claimed, those assets need not be reported on Schedule A. Therefore, a personal representative could be required to file Form 8971—because the estate’s gross value exceeds the estate tax exemption—even though there are no Schedules A, since all assets pass to a spouse or charity. However, penalties may still be assessed for failing to file Form 8971 in that situation.

The exclusion of marital deduction assets from the reporting requirement is inconsistent with the new law’s objective: enforcing consistent basis reporting. A surviving spouse could sell an asset inherited from the deceased spouse, and gain or loss would be reported. If the same asset had been left to a child, for example, the child would have received a Schedule A, which would have also

BY MEGAN FERKEL EARHART AND PAUL GORDON HOFFMAN

New Rules for Basis Consistency Reporting of Inherited Assets

Megan Ferkel Earhart is an associate, and Paul Gordon Hoffman a partner, in the firm Hoffman, Sabban & Watenmaker APC. They practice in the areas of estate planning, trust and estate administration, and tax and charitable planning. The authors wish to give special thanks to Erin L. Prouty, partner at Hoffman, Sabban & Watenmaker APC.
been attached to the Form 8971 filed with the IRS.

Form 8971 is not required if: 1) an estate tax return is filed solely to preserve and report the deceased spouse’s unused exemption to the surviving spouse, or 2) an estate tax return is filed solely to allocate generation-skipping transfer (GST) tax to a trust.8 A trustee who files a 706-GS(T) to report a GST taxable termination is also excluded from filing a Form 8971.9 This exception is surprising because the assets subject to GST tax as a result of a taxable termination receive a basis adjustment to fair market value, and the beneficiary will need to know the basis of the assets received for future income tax reporting.

Certain types of assets are excluded from being reported on Form 8971 and Schedule A:10 1) cash11 does not have a basis that changes; however, if cash is a foreign currency, the determination of fair market value at death may be subject to dispute; 2) income in respect of a decedent (IRD)12—these assets do not receive a basis adjustment as a result of the decedent’s death; 3) tangible personal property valued at less than $3,000, which is likely related to the estate tax return requirement for an appraisal of personal property valued at more than $3,000;13 and 4) property sold, exchanged, or otherwise disposed of prior to distribution. This last exclusion makes sense as the seller would be the personal representative, who should know the date of death value (basis). Also, this exclusion could provide a personal representative a convenient way to avoid reporting the value of certain assets to beneficiaries when there are privacy concerns. However, completing sales of assets before the reporting deadline may prove impractical.

Reporting Values

Section 1014(f) provides that the basis reported on Form 8971 “shall not exceed” the “final value” as determined for estate tax purposes, i.e., the value reported on the estate tax return. The final value is 1) the value reported on the estate tax return after the statute of limitations expires, generally three years,14 2) the value determined by the IRS once the statute of limitations for assessments and claims has expired without that value having been timely contested, 3) the value as determined by a final and binding agreement on all parties, or 4) the value determined by a court, once the court’s determination is final.15

This framework provides inherent problems. Practically, it seems that the value reported by a beneficiary on his or her income tax return should be the value reported on Schedule A to Form 8971. However, the value (i.e., basis) reported to the beneficiary may not be the true basis in the asset. While the value on Schedule A is the final value, the basis may change during the time the personal representative holds the asset (due to audit by the IRS, depreciation, improvements, or adjustments as a result of a flow-through from a partnership, limited liability company, or S corporation). Accordingly, the basis in the hands of the beneficiary may not be the same as the final value reported on the initial Schedule A provided to beneficiaries.

Practitioners might alert beneficiaries when transmitting Schedules A that the value of an asset received from a decedent may change, and the beneficiary will be informed of the change in the form of a Supplemental Schedule A. However, even if a Supplemental Form 8971 and Supplemental Schedule A are filed to report changes in values, the basis in the hands of the beneficiary still may be different from the amount reported. This inconsistency is at odds with the government’s goal of informing beneficiaries of basis to ensure consistency in reporting.

Supplemental Form 8971 and Schedule A

A personal representative must file a Supplemental Form 8971 and provide a benefi-
ciary with a Supplemental Schedule A if any changes occur that affect the final estate tax value. This includes the discovery of additional property, a change in the value of property due to litigation or audit, and a change in the identity of a beneficiary (for example, due to death, disclaimer, or bankruptcy). A Supplemental Form 8971 and Supplemental Schedule A are also required to correct certain errors, including a wrong taxpayer identification number, an incorrect beneficiary’s surname, an incorrect value of an asset being distributed to a beneficiary and reported on Schedule A, or a beneficiary’s address.

A Supplemental Form 8971 may, but need not, be filed to correct “inconsequential error or omission,” or to specify the actual distribution of assets previously reported as being available to satisfy the interests of multiple beneficiaries. The proposed regulations give little guidance as to what qualifies as an inconsequential error or omission, but Treasury Regulation Section 301.6722-1(b)(1) may provide some guidance. This regulation deals with the failure to furnish correct payee statements and defines an inconsequential error or omission as “any failure that cannot reasonably be expected to prevent or hinder the payee from timely receiving correct information and reporting it on his or her return or from otherwise putting the statement to its intended use.” It is likely that case law or other guidance will develop over time as to how to apply this regulation to Form 8971.

Subsequent Transfers

The need for basis consistency continues when an inherited asset is transferred by a beneficiary in a transaction in which the basis is determined in whole or part with reference to the transferor’s basis (i.e., by gift). The next recipient (or beneficiary) of the asset is more removed from the estate proceedings and thus less likely to know any basis information than the original beneficiary. Accordingly, the IRS has extended the new reporting requirements to certain subsequent transfers. To avoid potential penalties incurred by beneficiaries, practitioners may warn beneficiaries of the possibility that they will also be required to prepare and file a Supplemental Schedule A and provide it to a subsequent beneficiary. Although not required, it may be a nice accommodation to a client’s beneficiaries.

A beneficiary must provide a Supplemental Schedule A—but not Supplemental Form 8971—to the IRS and the beneficiary’s transferee within 30 days of the date of a subsequent distribution or transfer to a “related transferee.” A “related transferee” is defined in the proposed regulations as “any member of the transferor’s family as defined in Section 2704(c)(2), any controlled entity (a corporation or any other entity in which the transferor and members of the transferor’s family as defined in Section 2704(c)(2), whether directly or indirectly, have control within the meaning of Sections 701(b)(2)(A) or (B)), and any trust of which the transferor is deemed an owner for income tax purposes.”

This rule requires the filing of a Supplemental Schedule A if a beneficiary, who received property from a decedent, transfers the asset to his or her revocable grantor trust. The same is not true for the transfer to a beneficiary’s nongrantor trust. For example, assume a niece receives property from her deceased uncle. The niece transfers that property to her revocable grantor trust. The personal representative of the deceased uncle’s estate filed a Schedule A to report the transfer from the uncle to the niece upon the uncle’s death. The niece is now required to file a Supplemental Schedule A to report the con-
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tribution of that asset to her revocable grantor trust (which only benefits the niece during her lifetime). However, if she transferred the same asset to an irrevocable nongrantor trust, no Supplemental Schedule A would be required. The requirement to report transfers to a grantor trust, but not a nongrantor trust, seems arbitrary and nonsensical.

Mailing and Due Dates

The new filing requirement is effective for estates filing an estate tax return after July 31, 2015.23 The IRS has since issued transitional guidance making June 30, 2016, the due date for all Forms 8971 required to be filed after July 31, 2015, and before June 1, 2016.24 For all estate tax returns filed on or after June 1, 2016, the deadline is 30 days after the earlier of the due date of the estate tax return (including extensions) or the date the estate tax return was actually filed.27 For example, if a personal representative files the estate tax return on extension but before the extended due date, the preparer must file Form 8971 within 30 days after the estate tax return is filed, not 30 days after the extended due date.

A Supplemental Form 8971 and Schedule A are due 30 days after 1) the final value is determined, 2) the incorrect or incomplete information is discovered by the personal representative, or 3) a supplemental estate tax return is filed reporting additional assets.28 If one of these events occurs before the property is distributed to the beneficiary, Form 8971 and Supplemental Schedule A are due 30 days after distribution. If an asset was previously listed on Schedule A as an asset a beneficiary may receive, no Supplemental Form 8971 or Schedule A is required, unless the final value has changed. The personal representative must also file a Supplemental Form 8971 and Schedule A within 30 days of locating a beneficiary previously listed as “unknown” on Form 8971 and Schedule A.29

All Schedules A (and Supplemental Schedules A) must be attached to the original Form 8971 (or Supplemental Form 8971) filed with the IRS. A copy of each Schedule A must be delivered to the beneficiary to whom the Schedule A applies, and the preparer must show the date of mailing to each beneficiary on Form 8971. A beneficiary can be provided Schedule A in person, by e-mail, by U.S. mail to the beneficiary’s last known address, or by private delivery service (e.g., FedEx, UPS). To avoid potential penalties, a preparer should complete a proof of service and maintain a copy in the file as proof of timely mailing Schedule A to a beneficiary.

Form 8971 and Schedule A—and the supplemental documents—must be filed at the following address: Department of Treasury, Internal Revenue Service Center, Mail Stop #824G, Cincinnati, OH 45999.30

Penalties

Potentially harsh penalties may be incurred by a personal representative for 1) failing to timely file a Form 8971 and Schedule A31 and 2) failing to provide Schedule A to each beneficiary.32 The penalties range significantly from $50 per Form 8971, if it is filed within 30 days after the due date, to $260 per Form 8971, if it is filed more than 30 days after the due date, or not at all.33 The maximum penalty is $3,193,000 per year.34 These penalties do not apply to any failure that is shown to be due to reasonable cause.35

A beneficiary who reports his or her basis in an asset that is inconsistent with the value listed on Schedule A may be liable for a 20 percent accuracy-related penalty applied to the amount of tax not paid.36 As discussed above, the beneficiary’s basis may be different from the basis as reported on Form 706 due to depreciation and improvements, for example. A pending Technical Corrections Act will remove the penalty where the beneficiary properly reports a basis that is adjusted from the value reported on Form 706 and Schedule A.37 It may be useful for practitioners to include an explanation on an income tax return to account for the seemingly inconsistent basis reporting to avoid potential penalties.

Another severe consequence of failing to comply with Form 8971 is that if an asset is not included on Form 706 before the statute of limitations on assessment has expired and therefore not reported on Form 8971, the basis of the unreported asset will be zero. This punitive result could cause a significant income tax bill for an innocent beneficiary. For a California resident, the income tax could approach 38 percent on capital gains or over 50 percent on ordinary income, if the asset is later sold.

Outstanding Issues

Although some guidance has been provided in the proposed regulations to Sections 1014 and 6035, many preparers are left with questions. Two pressing issues are 1) reporting community property assets on Schedule A and 2) responding to questions on Form 8971 when the answer is unknown.

With regard to reporting community property, the IRS indicated that only the decedent’s assets (as reported on the estate tax return) should be included on Form 8971. The question arises then as to how the personal representative should report assets allocated between spouses on a nonpro rata basis. For example, suppose a married couple creates a living trust to hold a community property home. The husband dies first, and the trust divides into a survivor’s trust and bypass trust. Both spouses’ interests in the home receive a step-up in basis to fair market value to $1 million as of the husband’s death. The personal representative reports a 50 percent interest in the home on Schedule A to Form 8971. The trustee of the living trust allocates 100 percent of the home to the bypass trust and assets of equivalent value to the survivor’s trust. Should the trustee report the value of the entire home on Schedule A? Until the IRS issues guidance, it may be advisable to report the 100 percent value on Schedule A with a notation that 50 percent is attributed to the husband and 50 percent to the wife.

Concerning unknown answers to questions on Form 8971, it may be impossible to avoid penalties unless reasonable cause can be shown. Per instructions on Form 8971 the IRS will not accept a form with blanks or with “unknown” typed in a field. One of the items that must be filled in is the Social Security number of the decedent and each beneficiary. What should a preparer do if a decedent did not have a Social Security number (for example, because he or she was present in the United States on a visa that does not permit the holder to work)?38 The instructions to Form 8971 provide that the personal representative must obtain a Social Security number for the decedent. However, the Social Security Administration generally will not issue a Social Security number to a person who is not authorized to work in the United States.39

A personal representative has more options when a beneficiary does not have a Social Security number. A personal representative may alternatively use either a beneficiary’s Employer Identification Number, an Individual Taxpayer Identification Number, or any other number used by the IRS in the administration of tax law. However, the personal representative cannot force a beneficiary to obtain one of these numbers, and cannot obtain one for a beneficiary. A similar problem may arise when a beneficiary cannot be located; the preparer may not be able to obtain the beneficiary’s address or Social Security number to report on Form 8971. To reduce the risk of penalties, practitioners should explain on Form 8971 the efforts made to obtain any missing information and the reason they are not able to complete the Form.

Potential Changes to Form 8971

President Barack Obama’s 2017 Greenbook proposal would expand the property subject to the basis consistency requirement under Section 1014(f) to include 1) property distributed to charity or a spouse, if an estate tax return is required for a decedent, and 2)
property reported on a gift tax return.\footnote{General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals, Department of the Treasury February 2016, \url{available at https://www.treasury.gov} (last visited Oct. 18, 2016).}

Much remains to be seen as to how the IRS will process the recently filed Forms 8971, Schedules A, and whether the IRS will provide practitioners with additional guidance.

\begin{itemize}
  \item \footnote{I.R.C. §§6035(a), 6018(a), 2010(c).}
  \item \footnote{I.R.C. §§6035(a), 6018(a).}
  \item \footnote{See Instructions for Form 8971 and Schedule A (Jan. 2016) [hereinafter Form 8971 Instructions].}
  \item \footnote{Id.}
  \item \footnote{Id.; I.R.C. §1014(f)(2); Prop. Treas. Reg. §1.1014-10(b)(2) (although Prop. Treas. Reg. §1.1014-10 is not yet final, §1.1014-10(l) provides that these rules may be relied upon before the rules have been adopted as final).}
  \item \footnote{See I.R.S. Notice 2014-21 (IRB 2014-16).}
  \item \footnote{See Prop. Treas. Reg. §1.6035-1(a)(2).}
  \item \footnote{See Form 8971 Instructions.}
  \item \footnote{Prop. Treas. Reg. §1.6035-1(b)(1).}
  \item \footnote{Coin collection or bills with numismatic value are excluded from the definition of “cash.” It seems that virtual currencies (such as Bitcoin) also are not “cash” for this purpose. See I.R.S. Notice 2014-21 (IRB 2014-16).}
  \item \footnote{I.R.C. §691.}
  \item \footnote{See Schedule F of Form 706 (U.S. Estate (and Generation-Skipping Transfer) Tax Return); Treas. Reg. §20.2031-6(b).}
  \item \footnote{I.R.C. §6501.}
  \item \footnote{Prop. Treas. Reg. §1.1014-10(c)(1).}
  \item \footnote{Prop. Treas. Reg. §1.6035-1(e)(1), (2).

Note that if this is due to “reasonable cause” under I.R.C. §6724, there should not be a penalty. Cf. Chief Counsel Advice Memorandum 201615012 (Feb. 23, 2016).}
  \item \footnote{I.R.C. §6662.

Technical Explanation of the Technical Corrections Act of 2016, Joint Committee on Taxation (JCX-16-16) (Apr. 11, 2016).}
  \item \footnote{See Form 8971 Instructions.

  \item \footnote{General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals, Department of the Treasury February 2016, \url{available at https://www.treasury.gov} (last visited Oct. 18, 2016).}
\end{itemize}
THE FINAL stages of a major shift in federal securities laws took place in May 2016 when entrepreneurs and companies gained unprecedented access to capital. For the first time in the history of federal securities regulation in the United States, businesses may raise capital from the general public without registering a securities offering with the Securities and Exchange Commission and state securities regulators. This expansion of the funding universe is due to the Jumpstart Our Business Startups (JOBS) Act of 2012, designed to spur job creation by easing regulations governing “private” securities offerings to help early-stage companies grow. The JOBS Act removed previous restrictions on advertising securities offerings. Under the new law it is significantly easier for entrepreneurial clients to fund their ventures using other people’s money (OPM). However, lawyers must remain vigilant as regulators view lawyers as the gatekeepers who will fill in the regulatory void.

The JOBS Act legalized equity crowdfunding, fostered private peer-to-peer lending, created a new regime for regulating mini-IPOs, and paved the way for the SEC to create new sources of liquidity for early-stage investors through secondary “venture markets.” The law already has spawned new and innovative financial intermediaries dispensing capital to startup and growing businesses. It has been heralded as “democratizing” access to capital by “disintermediating” Wall Street from the process of selling securities. Many hail the JOBS Act, in particular its provisions for equity crowdfunding, as allowing everyday people to invest in an asset class previously reserved for venture capitalists. Crowds of small investors now may directly fund startup businesses that pique their interest. Yet there is concern that the new regime for raising capital from unsophisticated investors lacks sufficient investor protections.

The JOBS Act’s elimination of the regulatory burdens on private offerings, and the associated reduction in cost, will make public capital markets attractive to many. No longer will equity financing be reserved for those few with the resources to attract and engage Wall Street investment bankers and lawyers.

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This “Uberization” of capital markets will make capital more readily accessible to every budding entrepreneur, and it will have significant ramifications for the practice of business law.

A growing awareness of access to capital by the public will lead to a demand for legal services. Lawyers have an opportunity to expand their business practices, but they will need to better understand the specialized field of securities law. The new laws and rules raise many new questions, the answers to which often are informed by years of old interpretations and customary practices in the law of corporate financing transactions. Today’s business lawyers must have at least a working knowledge of the new methods and rules for raising capital under Regulation CF (crowdfunding), Regulation D, and Regulation A under Titles II, III, and IV of the JOBS Act. They must understand the interplay between federal and state securities laws. They must advise clients about the often draconian statutory liabilities under those laws. And they must be clear about their role as securities lawyers and the liabilities they assume.

When Congress enacted the Securities Act of 1933 (Securities Act) and Securities Exchange Act of 1934 (Exchange Act) and created the Securities and Exchange Commission, the business of raising investment capital—taking OPM—became subject to extensive regulation. The federal securities laws, and each state’s “blue sky” securities laws, mandate that all offers and sales of securities be registered with the SEC and qualified with state securities regulators unless exempt from such registration.

Prior to the JOBS Act, the most common exemption from registration was for nonpublic securities offerings, which placed strict limitations on soliciting investors and advertising the offering. The SEC and the courts had long interpreted the nonpublic offering exemption to prohibit any form of general solicitation. They did not, however, set forth clear guidelines for determining what constituted a private offering for purposes of the exemption. The Supreme Court in 1953 outlined the contours of what constitutes a private offering for purposes of the exemption. In SEC v. Ralston Purina Co., the Court examined the knowledge of the investor and its relationship with the issuer as a basis for distinguishing a private offering from a public offering. The boundaries, however, were far from clear. Prior to the SEC’s promulgation of Regulation D in 1982, many members of the securities bar were uncomfortable rendering “no registration” opinions. Even after Regulation D, until the enactment of the JOBS Act, issuers, who in litigation bear the burden of proving an exemption from registration, typically restricted their unregistered offerings to prospective investors with whom they could demonstrate a “pre-existing substantive business relationship.”

In recent years, organized groups of individuals with high net worth (angel investors) have been a source of early-stage capital, but attracting the attention of angel investors is nearly impossible without some initial seed capital to validate or prove a business model or product. The only other alternative for raising capital—soliciting the public—required registering the securities offering with the SEC, the same process undertaken by companies going public through an initial public offering (IPO). Registration is cost-prohibitive for most early-stage companies. Even if a company could afford the legal and audit fees charged for public offerings, after the dot-com crash in the early 1990s, the public equity markets became inhospitable for early-stage small (less than $50 million) IPOs.

Changes in market regulation, including the decentralization and deregulation of commissions, shrinking profits of smaller investment banking firms, increased regulation of those investment banking firms by the Financial Industry Regulatory Authority (FINRA) in response to microcap stock frauds, and other structural changes to the industry, resulted in the exodus of regional investment banking underwriters to small public offerings. The Securities Act’s restrictions on soliciting investors—well-intentioned in the aftermath of the stock market crash of 1929 and the Great Depression—made the ambition of successfully raising capital for startups unattainable for most people. It relegated entrepreneurs to raising seed capital from friends, family, and others with whom the entrepreneur had the requisite relationship. Small issuers were frequently unable to comply with Securities Act provisions because of a combination of exorbitant costs, unworkable resale provisions, ambiguity, and taint of prior illegal stock sales.

Consequently, an entrepreneur’s parents, family, and friends, and the geographic neighborhood in which one lived were significant factors in determining who received funding, who became owners of a business, and what demographic eventually accumulated capital and wealth in this country. To close the capital gap for early-stage financing, stimulate job growth, and address issues of unequal access to capital, in 2012, President Obama signed into law the JOBS Act. In relaxing the restrictions on soliciting investors, the new law reflects the advent of the Internet, modern communication technology, and social media, which made the 90-year-old restrictions on advertising securities offerings increasingly impractical.

The JOBS Act dramatically changed the rules relating to private securities offerings by creating three new methods of conducting public offerings that are exempt from SEC registration. These offering exemptions are found in Titles II, III, and IV of the JOBS Act and are often referred to by these JOBS Act titles. The differences among the three exemptions relate to the size of the offering, investor qualifications, and manner in which the securities may be offered. The new exemptions from registration afforded by Title II and Title IV allow unrestricted general solicitation of investors; in effect, they permit unregistered public offerings. Title III provides a new exemption for selling securities through crowdfunding. All three exemptions preempt certain aspects of state blue sky securities law regulation.

**Title II: Rule 506(c) of Regulation D**

Title II of the JOBS Act dramatically changed the rules for raising capital from accredited...
investors who, in the case of an individual, is a person with 1) an individual income in excess of $200,000 in each of the two most recent years or joint income with that person’s spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year, or 2) a net worth in excess of $1 million excluding home equity. Title II amended Rule 506 of Regulation D by adding new paragraph c, which eliminated completely the prohibition on general solicitation. This means that a company can widely advertise its offering as long as it takes “reasonable steps to verify” that investors are accredited, “using such method as determined by the Commission.” Issuers must have a reasonable belief that all purchasers are accredited investors. Prior to Title II of the JOBS Act, which went into effect in September 2014, issuers customarily relied on self-certifications, or check-the-box certifications as to accreditation. Self-certifications will not satisfy the new verification requirement applicable to public offerings under Rule 506(c). Rule 506 of Regulation D has become the cornerstone of the regulatory regime for nonregistered offerings. The rule provides bright line “safe harbor” rules to establish an exemption from SEC registration. In 1996, Congress addressed the duplication of dual federal and state securities regulation in the National Securities Markets Improvements Act of 1996, and preempted state blue sky registration or qualification of federal covered securities, i.e., those offered in compliance with Rule 506 of Regulation D. In addition to federal preemption, the absence of any limitation in Rule 506 on the offering amount and number of investors as well as absence of specific disclosure requirements for accredited investors made Rule 506 the most commonly used private offering exemption. Today, 99 percent of all private offerings under Regulation D are conducted pursuant to Rule 506. Moreover, amounts raised through unregistered securities offerings have outpaced the level of capital formation through registered securities offerings during recent years. In 2014, there were 33,429 Regulation D offerings reported on Form D filings, accounting for more than $1.3 trillion raised. The JOBS Act adds securities offered pursuant to Title III and Title IV to the list of securities preempted from state regulation. The new rules provide a nonexclusive safe harbor for an issuer to satisfy its verification requirement by obtaining tax returns to verify income, or bank or brokerage statements and a credit report to verify net worth. However, many investors are unwilling to furnish confidential tax returns and brokerage statements. Fortunately, the issuer is not required to use the safe-harbor methods of verification. In assessing whether an issuer has taken reasonable steps to verify that investors are accredited, the SEC takes a principles-based approach that does not depend on bright-line rules but relies rather on the particular facts and circumstances of each purchaser and transaction to determine whether the steps taken are “reasonable.” Under this principles-based approach, the documentation, if any, that an issuer should obtain from a potential investor will depend on answers to questions such as:

- How much information about the prospective purchaser does the issuer already have? The more information the issuer has indicating that the person is an accredited investor, the fewer verification steps it may have to take to comply with the rule’s requirements. For example, membership in an established angel investor group is information that may affect the likelihood of the person being an accredited investor.

- How did the issuer find the prospective investor? A person that the issuer located through publicly accessible and widely disseminated means of solicitation may need to undergo a greater level of verification scrutiny than a person who may have been prescreened as an accredited investor by a reasonably reliable third party.

- Are the terms of the offering such that only a person who is truly an accredited investor could participate? The ability of a purchaser to satisfy a minimum investment amount requirement that is sufficiently high such that only accredited investors, using their own cash, could reasonably be expected to meet it is relevant in deciding what other steps are needed to verify accredited investor status.

Lastly, the SEC envisioned a role for third parties that may wish to enter into the business of verifying the accredited investor status of prospective investors on behalf of issuers and allowed for such third-party verification under the principles-based approach as long as the issuer has a reasonable basis to rely on such third party.

Securities sold pursuant to Rule 506 of Regulation D must contain restrictions on transferability, and the issuer must exercise reasonable care to assure that the purchasers of the securities do not intend to act as underwriters by engaging in a distribution of the securities purchased. Issuers should affix a legend on the share certificates setting forth the restrictions on transferability and make reasonable inquiry to determine if the investor is acquiring the securities for himself and not for other persons. Title II amendments to Regulation D also implemented a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act that directed the SEC to make the Rule 506 exemption unavailable for offerings in which certain disqualified persons (“bad actors”) participate, subject to a “reasonable care” exception. There is no dollar limit on offerings under Rule 506 and very few other limitations.

The old Rule 506, which prohibits general solicitation but allows issuers to include up to 35 nonaccredited investors, remains available in paragraph (b) of Rule 506. Issuers relying on the old rule also need not verify that investors are accredited, as required by new Rule 507(c). Moreover, recently issued Compliance and Disclosure Interpretations by the staff of the SEC Division of Corporation Finance expand the availability of the old rule. These interpretations clarify that in appropriate circumstances communications in a closed network among members of an informal, personal network of individuals with experience investing in private offerings will not be deemed to be a general solicitation. Issuers may now conduct offerings on angel investor networks and make presentations at demo days and venture fairs without risk that such activities will be deemed to be a
general solicitation.” On the other hand, the staff also clarified that one method of establishing the absence of a general solicitation—showing a preexisting “substantive business relationship” with prospective investors—requires that the issuer possess sufficient information to evaluate the offeree’s financial circumstances and sophistication. Self-certification, without any other information about the prospective offeree, is not enough to be considered substantive.

Despite the staff’s recent efforts to provide guidance on issues arising under the JOBS Act, answers to many questions require resorting to years of SEC staff interpretation and judicial precedent. For example, in response to the question, “What information can an issuer widely disseminate about itself without contravening Regulation D’s prohibition on general solicitation?” the staff responded that factual business information that “does not condition the public mind or arouse public interest in a securities offering” will not violate the rule. To understand the response, however, one must look to the SEC staff’s long-time guidance on when such communications will be deemed an “offer” and be aware that courts have interpreted the term for securities law purposes broadly beyond the common law concept of an offer.

**Title IV: Regulation A+**

Title IV of the JOBS Act is commonly known as “Regulation A+” and has also been dubbed a “mini-IPO.” Once qualified, the offering may be sold to anyone. There is no requirement that the investor be accredited or sophisticated, no restriction on the means of solicitation, and no federal restriction on transferability of the securities. Effective since June 2015, it amends the former SEC Regulation A by increasing the old offering limit of $5 million to $50 million. An offering under the new Regulation A requires an offering circular containing specific disclosures similar to those made in an IPO prospectus, and the offering is subject to SEC review and qualification of the offering circular. The offering circular must include financial statements consisting of the prior year’s balance sheet and income statements for the most recent two years. The SEC review process for Regulation A+ offerings is similar to the registration process for a registered IPO. The staff of the SEC’s Division of Corporation Finance reviews all Regulation A+ offering circulars and approximately 30 days from the filing date of the offering circular on Form 1-A, the staff will issue its written comments. The company responds to these staff comments by filing a series of amendments to the offering circular until all staff comments are resolved. Only then will the SEC declare the offering statement “qualified.” No sales of securities may be made until the SEC declares the statement qualified. In most cases, the time period from SEC filing to the effective date is at least 60 days and in many cases much longer.

A principal benefit of Regulation A+ is its “test the waters” provisions. An issuer may solicit indications of interest before and after an offering circular is filed. While no sale commitments may be accepted until the offering circular is qualified by the SEC, there are few restrictions on the content of test-the-waters materials. Through a social media campaign, for example, companies may ask potential investors for their contact information and the dollar amount of their investment interest by asking them to reserve shares for purchase when, and if, the SEC qualifies the offering. If there is sufficient interest, upon qualification of the offering by the SEC, the issuer may then formally offer and accept subscriptions from those prospective investors who had previously expressed interest in the offering.

Regulation A+ has two tiers: tier 1, with a maximum offering limit of $20 million, and tier 2 with a maximum offering limit of $50 million. The principal difference between them is that tier 2 offerings preempt state securities laws. The SEC left intact state blue sky regulation of tier 1 offerings under Regulation A+. Another difference between the two tiers is that tier 2 offerings require a financial statement audit, and the issuer must file with the SEC ongoing annual, semiannual, and current reports. Also, nonaccredited investors in a tier 2 offering may not invest more than the greater of 10 percent of their net worth or annual income in any single Regulation A+ offering. Finally, because there is no preemption of state securities laws with tier 1 offerings, audited financial statements in most cases will be necessary even though the SEC does not require financial statements to be audited in tier 1 offerings. This provision is necessary because many states require audited financial statements in order to qualify the offering in the state.

The ongoing SEC reporting required of companies conducting tier 2 Regulation A+ offerings is considered to be a “lite” form of the periodic reporting required of companies that conduct registered offerings. Unlike companies registering their securities offerings under the Securities Act on Form S-1, an issuer selling securities under the Regulation A exemption from registration does not become subject to the full regulatory regime under Section 12 of the Exchange Act, which automatically applies to issuers registering an offering under the Securities Act. Companies conducting registered offerings must file periodic reports—annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K—proxy statements and beneficial ownership reports by the company’s officers, directors and 10-percent shareholders.

The annual financial statement audit required of tier 2 Regulation A+ issuers need not be performed by auditors who are registered with the Public Company Accounting Board, which is a requirement for audits of SEC-registered companies. The six-month semiannual report required of Regulation A+ issuers need only contain financial state-

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**Solving the Facebook Problem**

A privately held company automatically becomes subject to the full SEC regulatory regime under the Exchange Act once it elects to register its initial public offering under the Securities Act. A privately held company may also be required to register under the Exchange Act, if its assets and shareholder base grows to a certain size. One of the more important changes included in the JOBS Act was to increase these Exchange Act registration thresholds to mitigate what has been known as the Facebook problem, a problem confronting many startups with large numbers of stockholders. Prior to the JOBS Act, Section 12(g) of the Exchange Act required that a company with more than $10 million in total assets register any class of securities held by more than 500 shareholders of record, whether accredited or not. This Exchange Act registration triggers all of the SEC’s regulations governing publicly traded companies, including, among others, periodic reporting, insider security transaction reporting, proxy statement filing, and short-swing insider trading prohibitions. The JOBS Act raised the thresholds for registration (and termination) of registration for a class of securities under the Exchange Act. As a result, an issuer that is not a bank, bank holding company, or savings and loan holding company is required to register a class of equity securities if it has more than $10 million total assets and the securities are held of record by either 2,000 or 500 persons who are not accredited investors. The JOBS Act also directed the SEC to revise the definition of “held of record” to exclude securities held by persons who received the securities under an employee compensation plan in transactions exempted from registration under the Securities Act. This last requirement addressed the Facebook problem. Prior to its IPO, Facebook, having more than $10 million in assets and more than 500 stockholders, decided to register its IPO under the Securities Act because it would have been required to register its common stock under the Exchange Act in any event.
ments that management certificates are prepared in accordance with generally accepted accounting principles in the United States. There is no requirement that the six-month financial statements in the semiannual report be reviewed by an independent auditor; as required for quarterly reports of SEC-registered companies. The ongoing reporting regime for tier 2 Regulation A+ issuers also includes a “lite” current events requirement to report certain specified events, including fundamental changes in the issuer’s business, changes in control of the issuer, a departure of the principal executive officer, principal financial officer, or principal accounting officer, and any unregistered sales of 10 percent or more of outstanding equity securities.28

Restrictive securities laws in effect for the 90 years prior to the JOBS Act made it difficult to start and finance businesses for those who did not have access to capital sources or friends and family to provide funding. The JOBS Act enables anyone to reach out to capital sources and raise equity capital. But the “disintermediation” of Wall Street places a heavier burden on the business attorney. Without professional financial intermediaries, such as investment bankers, it will be up to business attorneys to navigate the new securities rules and regulations to ensure that they and their clients follow the right path.

[Editor’s note: In a subsequent issue of Los Angeles Lawyer, Part 2 of this article on the JOBS Act will discuss Title III Crowdfunding and how attorneys can counsel clients to raise capital while managing the securities law liability to their clients and themselves.]

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2 Equity crowdfunding involves investments in “securities,” as the term is defined under the Securities Act of 1933 (Securities Act) and Securities Exchange Act of 1934 (Exchange Act). See §2(a)(1), 15 U.S.C. §77b(1); §2(a)(10), 15 U.S.C. §78c(a)(10). A “security” includes not only stocks, bonds, limited partnership and limited liability company membership interests, but also any “investment contract” that is “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.” SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946). Prior to the JOBS Act, private offering exemptions from the Securities Act’s registration requirement did not allow for equity crowdfunding, which, by definition, involves a public offering to the crowd.
8 Ralston Purina, 346 U.S. 119.
10 Two surveys cited by the SEC last fall concluded that the average initial compliance cost associated with conducting an IPO is $2.5 million, followed by an ongoing compliance cost for issuers, once public, of $1.5 million per year. The SEC staff notes that these estimates should be interpreted with the caveat that most firms in the IPO Task Force surveys likely raised more than $1 million. See IPO TASK FORCE, REBUILDING THE IPO ON-RAMP (Oct. 20, 2011), available at http://www.sec.gov.
14 JOBS Act, §201(a)(1).
15 JOBS Act, §201(a)(1).
16 JOBS Act, §201(a)(1) (accredited investors are persons that the issuer reasonably believes come within the specified categories).
22 17 C.F.R. §230.502(d).
23 17 C.F.R. §230.506(d).
New partnership audit rules to be enacted in 2018 provide important changes to existing regulations that need to be considered in drafting current partnership agreements.

**Finding the Path**

IN 2015, President Barack Obama signed into law the Protecting Americans From Tax Hikes Act, which replaces the consolidated partnership audit rules under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). This act sets forth certain corrections to the new partnership audit rules. These rules, which become effective for most partnerships beginning in 2018, impact not only audit procedures but the very essence of how partnerships are taxed. The delayed effective date provides existing partnerships and limited liability companies taxed as partnerships the opportunity to amend their organizational documents—namely their partnership or LLC agreements—in order to take the new partnership audit rules into account. Partnership and LLC agreement drafters should now take the new partnership audit rules into account in drafting new partnership and LLC agreements.

The risks of a general partnership, limited partnership, or limited liability company being audited by the Internal Revenue Service are low. For example, in fiscal year 2015, only 19,212 partnerships were audited. Moreover, IRS partnership audits are often superficial. The IRS has identified particular difficulty auditing partnerships with more than 100 partners.

Reacting to the IRS’s difficulty with auditing large partnerships, Congress passed the new partnership audit rules in November 2015. However, these rules are not limited to large partnerships but apply to practically all partnerships. They grew out of a bill that languished in committee in Congress, but the impact of enforcing the new partnership audit rules had a large revenue estimate and they were attached to a budget bill, which passed quickly. Consequently, the new rules did not receive the benefit of extensive committee hearings, a written committee report, and extensive comments.

The new partnership audit rules are important for anyone who drafts partnership agreements or is a partner in a partnership (such as a law firm or accounting firm organized as a partnership). These rules generally go into effect in January 2018; however, currently drafted partnership agreements should take the new partnership audit rules into account. Current audit rules (the TEFRA audit rules) will remain in effect until the effectiveness of the new partnership audit rules.

Three terms and three features are par-

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Particularly important under the new partnership audit rules. The terms are: 1) a partnership representative is the person designated by the partnership to handle the partnership audit, 2) the reviewed year is the year under audit, and 3) the adjustment year is the year in which the IRS audit is concluded.

The first important feature of the new partnership audit rules is that they provide for an IRS audit of the partnership as an entity rather than for audits of partner operations at the individual partner level. Partners are bound by the result of the partnership audit. The new rules, however, may result in fewer partnership audits as many more partnerships may elect out of the new partnership audit rules.

Second, the new partnership audit rules provide for a partnership representative. The partnership representative is the tax audit czar. The partnership representative is the sole representative of the partnership in the IRS audit. The partnership representative can agree to an audit settlement that binds the partnership and all the partners. The partnership representative is the only one who can agree to this settlement. Also, the partnership representative can extend the partnership's statute of limitations. The partnership and every partner is bound by actions taken under the new partnership audit rules by the partnership acting through the partnership representative. The partnership and every partner is bound by any final decision in a proceeding brought under the new partnership audit rules.

Third, the IRS assesses any tax deficiency at the end of the audit—the imputed underpayment—against the partnership rather than against the partners. This can transfer the burden of tax audit adjustments from reviewed-year partners to adjustment-year partners. Dealing with fairly apportioning this burden among the partners can be an important task for the partnership agreement drafter. The drafter should deal with the problem that the partnership may be paying taxes that in theory should be paid by the reviewed-year partners.

The new partnership audit rules create three classes of partnerships. Some partnerships will elect out of the new partnership audit rules. Some partnerships rules will be subject to consolidated partnership audits, and the partnership will pay tax on account of audit adjustments. Some partnerships will be subject to consolidated partnership audits, but these partnerships will push out adjustments to reviewed-year partners. The reviewed-year partners will pay the resulting tax in the tax years in which they receive notice of the adjustments.

Under the new partnership audit rules, each partner is required to report partnership items on the partner’s personal return in a manner that is consistent with the treatment of the item on the partnership return. A partner nevertheless may report partnership items in a manner inconsistent with the partnership tax return and the partner's Schedule K-1. The IRS then can use an expedited procedure to assess and collect a resulting underpayment from the partner as a math error.

The IRS audits the partnership at the partnership level rather than auditing the partners individually on partnership matters. The new rules provide that any audit adjustment must be made in a partnership audit. The IRS assesses the deficiencies in tax, interest and penalties against the partnership rather than the partners. Moreover, the IRS assesses the deficiency against the partnership at an assumed tax rate.

The IRS assesses an underpayment of tax against the partnership in the adjustment year, not in the reviewed year. This revolutionary development can result in adjustment-year partners bearing the tax effects of mistakes that the partnership made in the reviewed-year return. A skillfully drafted partnership agreement can require reviewed-year partners to reimburse the partnership for the tax that the IRS assesses against the partnership.

The new partnership audit rules calculate the imputed underpayment—the partnership’s tax liability resulting from audit adjustments—at the highest individual or corporate tax rates. The imputed underpayment can be reduced on account of tax-exempt partners and other adjustments. The partnership may seek further to reduce the imputed underpayment amount 1) by providing information about the tax status of partners (such as tax-exempt partners) and about the nature and amount of items of income or gain, 2) by reviewed-year partners filing amended returns with payment of the adjusted tax, or 3) on the basis of other factors in future regulations or guidance.

Future U.S. Treasury regulations will clarify the precise rules for calculating imputed underpayments. The rules may take into account types of persons who are partners and their maximum tax rates, tax-exempt
partners, foreign partners, partners that are flow-through entities, character of income (tax-exempt, ordinary, capital gains), loss limitations of various types (at-risk, passive losses, and so forth), and other adjustments as provided in regulations.30

Many uncertainties still exist about how regulations will compute the imputed underpayment. One of the harsher rules for computing imputed underpayments applies when the IRS audit reallocates income or loss from one partner to another.31 The reallocation does not result in a new income increase to the partnership. The imputed underpayment is based on the increased income (or decreased loss) allocation to the partner to whom income is reallocated and does not provide an offset for the decreased income (or increased loss) allocated to another partner.32

The new partnership audit rules also fail to clarify whether capital account adjustments for audit adjustments are made in the reviewed year or in the adjustment year. Audit adjustments presumably are usually allocated to partners in accordance with partners’ interests in the partnership.33 The new rules do not clarify whether audit adjustments to partners’ bases in their partnership interests are made in the reviewed year or in the adjustment year. Furthermore, they do not clarify how to account for the partnership’s payment of the imputed underpayment.

Election Out

Many partnerships with 100 or fewer qualifying partners will be able to elect out of the new partnership audit rules.34 The election out can result in partnership activities being included as part of a partner audit. These audits will be conducted under the partner-level audit rules that applied to pre-TEFRA audits.

Many partners will prefer this IRS partner-level audit to a partnership-level audit. Election out will mean that the partnership will not be audited in a consolidated proceeding. The IRS then can audit partnership activities only as part of a partner-level audit. Auditing the partnership through separate partner audits is considerably more cumbersome for the IRS than a consolidated partnership audit; an IRS partner-level audit is not likely to include a comprehensive audit of partnership activities. Partners may look to the election out as a practical manner in which to escape effective IRS audit of partnership activities. Indeed, TEFRA was introduced in significant part on account of the difficulty that the IRS had in auditing partnerships through partner-level audits. The IRS indicated that it needed to audit partnerships on a consolidated basis.35

TEFRA provided for the exclusion of certain small partnerships from TEFRA-consolidated audit rules.36 “Small partnerships” were defined as partnerships that passed two tests. First, the partnership must have 10 or fewer partners at all times during the tax year.37 A married couple filing jointly and their estates are treated as one partner.38 Second, all partners must be U.S. persons, resident aliens, C corporations (not an S corporation), or estates of deceased partners.39

The new partnership audit rules expand the class of partnerships that can elect out of the new partnership audit rules to include many partnerships with 100 or fewer qualifying partners.40 The nonconsolidated IRS audit of this type of partnership creates great difficulties for the IRS.41 No single partner speaks for the partnership in a nonconsolidated audit.

The nonconsolidated IRS audit may pose difficulties for the partners and the partnership. An audited partner may believe that the partnership should contribute to funding the partner’s audit expenses. Also, the partnership may fail to cooperate with the partner’s information requests. The partnership may deny the partnership partners access to partnership records or employees. The partnership agreement drafter may appropriately address these issues.

A partnership of 100 or fewer qualifying partners42 may elect out of the new partnership audit rules if each partner is an individual, a deceased partner’s estate, a C corporation, a foreign entity that would be required to be treated as a C corporation if it were a domestic entity, or an S corporation.43

This list of permitted partners does not contain trusts or partnerships. Certain trusts, and perhaps some partnerships, may be permitted as qualifying partners under future regulations. The law has not yet resolved whether disregarded entities are qualifying partners.44 Any partner who is not on this list and not permitted by future regulations may disqualify the partnership from electing out of the new partnership audit rules.

The election out of the new partnership audit rules must be made with a timely filed return for the taxable year.45 Election out is made on a year-by-year basis. The partnership must include the name and taxpayer identification number of each partner of the partnership in the election out.46

A partnership agreement may impose transfer restrictions on partners to ensure that every transferee partner qualifies for the partnership to make the election out under the new partnership audit rules. These transfer restrictions may be an important part of a well-drafted partnership agreement.

An election out of the new partnership audit rules may give the partnership practical immunity from an effective IRS audit. The partnership activities technically can be audited as part of an individual partner audit. That audit is difficult for the IRS to undertake.

The IRS may try to audit all partners. An IRS audit of the partnership through separate individual audits of the partners may be practical if all partners live in the same IRS district. Then, IRS partner audits can be assigned to the same auditor. The IRS audit may proceed as a lead audit of a partner, with audits of other partners suspended until the lead audit is resolved. Coordinating IRS individual partner audits is more difficult if partners live in different IRS districts, which is often the case.

Each partner (or the partner’s accountant or the partner’s counsel) represents himself in the partner’s individual IRS audit. Each partner may take the partner’s own tax position on partnership tax issues. Each partner may make the partner’s own arguments to the IRS. The IRS reaches a settlement on a partner-by-partner basis. Individual partner audits can lead to inconsistent audit results or inconsistent court decisions.

Election out of the new partnership audit rules will be the solution for many partnerships. However, the new partnership audit rules also permit the partnership to push out adjustments to the tax returns of reviewed-year partners for the year in which they receive statements of the adjustments. The reviewed-year partners then pay the additional tax resulting from the audit adjustments in the year in which the partners receive statements of the adjustments.47

The push-out election requires the partnership to be diligent. The partnership has 45 days after receiving the final notice of partnership adjustments within which to make the push-out election.48 The partnership must issue a statement of adjustments to the reviewed-year partners showing their revised distributive shares as determined in the audit.49 The reviewed-year partners then will include the audit adjustments in computing tax liability for their tax years in which they receive the statement of adjustments from the partnership.50

The election to push out adjustments is likely to be popular for partnerships that cannot elect out of the new partnership audit rules. Any partnership may make the push-out election. Under this alternative, the partnership furnishes each reviewed-year partner a statement of the reviewed-year partner’s share of the audit adjustments—similar to Schedule K-1.51 Each reviewed-year partner increases its tax on account of the pushed-out adjustments for the year in which the partner receives the statement of adjustments.52

Many questions linger concerning how the push-out election will work, particularly when a partner is in a tiered partnership. The first-tier partner may have to pay tax
1. The new partnership audit rules apply to all partnership audits for taxable years beginning after December 31, 2015.
   True.  False.

2. The scope of the new partnership audit rules is limited to partnerships with more than 100 partners.
   True.  False.

3. If a partnership elects out of the new partnership audit rules, the IRS audit must be conducted under the TEFRA audit rules.
   True.  False.

4. Any partnership with 100 or fewer partners can elect out of the new partnership audit rules.
   True.  False.

5. The new partnership audit rules provide for the partnership representative to receive reasonable compensation for his services in the partnership in the partnership audit.
   True.  False.

6. The partnership’s accountant or attorney can be selected as the partnership representative.
   True.  False.

7. The new partnership audit rules provide that the general partner of a limited partnership has the right to remove the partnership representative.
   True.  False.

8. The new partnership audit rules permit the partnership to elect to push out audit adjustments to adjustment-year partners, who then are required to pay tax on those audit adjustments.
   True.  False.

9. The new partnership audit rules clarify that the partnership can push out audit adjustments to the ultimate taxpaying partners through tiers of partnerships that are partners in the audited partnership.
   True.  False.

10. Under the new partnership audit rules, the IRS has the option of making adjustments in a partner’s share of partnership items either in the audit of the partnership or in an audit of the partner.
    True.  False.

11. In computing the imputed underpayment, income and losses are netted together without considering character and then are taxed at a specified tax rate that can be modified by the IRS.
    True.  False.

12. If the partnership elects out of the new partnership audit rules, the partners must cooperate and agree on the tax arguments that they will make in audit.
    True.  False.

13. If the partnership makes the push-out election, it must do so within 60 days of the partnership’s receiving notice of institution of the partnership audit.
    True.  False.

14. The partnership must inform reviewed-year partners of their partnership audit adjustments as a condition to the partnership making the push-out election.
    True.  False.

15. Under the new partnership audit rules, an audit settlement agreement with the IRS must be approved by the partnership and the partnership representative.
    True.  False.

16. TEFRA rules cease to apply to existing partnership audits after 2017.
    True.  False.

17. The new partnership audit rules require that a partner report his partnership tax items in accordance with the treatment of those tax items on the partnership return.
    True.  False.

18. The election out of the new partnership audit rules must be made within 30 days of notice of institution of an IRS audit.
    True.  False.

19. The IRS can use an expedited procedure to assess a partner’s tax liability as a math error if the partner reports an item in a manner inconsistent with the partnership return.
    True.  False.

20. A partnership under audit under the new partnership audit rules may be able to reduce its imputed underpayment by reviewed-year partners filing amended returns with payment of the adjusted tax.
    True.  False.
on account of pushed-out adjustments, or perhaps the first-tier partner may be able to push out the audit adjustments through successive tiers of partners that are partnerships. Also, a partnership or LLC agreement may bind the partnership to push out partnership adjustments to reviewed-year partners under the new partnership audit rules. These questions will have to wait for regulations for resolution.

The drafter of a partnership agreement for a partnership that plans to elect out of the new partnership audit rules should consider whether the partnership should make a financial contribution to audit defense and whether partners and the partnership should agree to cooperate with the audited partner in the audit.

A partnership agreement for a partnership that plans to make a push-out election should address: 1) how the partnership will approve the push-out election; 2) funding the audit (including funding after dissolution of the partnership); 3) appointing, removing, and replacing the partnership representative; 4) responsibilities of the partnership representative; 5) limitations and controls on the partnership representative; 6) expenses of the partnership representative; and 7) indemnification of the partnership representative. The partnership agreement also might require partner cooperation with the partnership audit.

**Partnership Representative**

The partnership acts through its partnership representative. The partnership representative has the sole authority to act on behalf of the partnership in the partnership audit, in particular to enter into agreements with the IRS in connection with the audit. The settlement agreement between the partnership representative and the IRS binds the partnership and the partners.

The partnership representative in theory may be anyone who has “a substantial presence in the United States.” While uncertainty exists concerning what this means, the concept presumably will be clarified in regulations. The partnership representative typically will be a managing partner, managing member, general partner, another partner or LLC member, or the LLC manager. The partnership representative also may be a partnership employee. Some partnerships will choose counsel or an accountant as a partnership representative. The partnership also may appoint a professional partnership representative.

The natural selection of partnership representative for many partnerships will be the general partner or managing member. However, passive investors should consider the possibility of conflicts that may develop between partners and the partnership representative. Thus, the general partner or managing member is not necessarily the best choice for partnership representative, although the general partner or managing member should be a common choice.

An LLC manager, an officer, or an employee could serve as the partnership representative. If so, the partnership agreement should impose reasonable controls over the partnership representative so that he or she truly serves the interests of the partnership.

The professional partnership representative may emerge from within the ranks of the partnership. For example, accountants or attorneys may serve as partnership representatives. Serving as partnership representative will create new challenges for accountants and attorneys.

The Internal Revenue Code provides the partnership representative with broad decision-making power. Moreover, the partnership representative is not necessarily a simple agent of the partnership. Yet, for these reasons a partnership representative should confirm that his or her errors and omissions policy will cover the activities performed in this role.

The partnership representative should be someone with integrity who can interact in a professional manner with the IRS and understand the tax laws or should at least have the capacity to learn enough about the tax laws to direct the audit intelligently. The partnership representative also should be someone who will follow directions from the partnership management. In general, because the partnership representative has broad discretion in the partnership audit and subsequent court proceedings, the partnership should select someone who is reliable and able to direct partnership tax litigation as well as possesses the temperament and knowledge to be a successful leader in an audit.

Finally, since partnership audits and subsequent administrative and judicial proceedings can take many years to resolve, the partnership representative should be someone young enough that he or she will be effective through the term of the audit.

A partnership agreement for a partnership that may be subject to IRS audits under the new partnership audit rules should contain provisions that specifically address the partnership representative. In addition to stating the partnership representative’s qualifications, these provisions may address rules for the position, including the partnership representative’s selection, resignation, removal, and replacement; compensation; powers and limitations on these powers; and the relationship between the partnership representative and partnership management. The partnership agreement also might address management approval of decisions of the partnership representative, preparation and approval of a litigation budget, engagement and supervision of accountants and counsel for the IRS audit, and indemnification of the partnership representative.

Drafters of partnership agreements should also consider a provision that requires the partnership representative to propose audit and litigation strategy guidelines for approval in advance by the partnership management and to undertake the audit and litigation in accordance with those audit and litigation strategy guidelines. The partnership agreement could also provide that the partnership representative must make written filings with the IRS or with a court only after seeking prior review and approval by partnership management.

In addition, the partnership agreement could require that the partnership representative give partnership management prior notice of meetings with or appearances before the IRS or other governmental authorities, court appearances, and filing dates. The partnership agreement could require that the partnership representative make regular and as-needed written and oral reports to partnership management and written reports to the partners on audit status, trial status, legal research, expert reports, witnesses, depositions, and other information issues, discovery assessment, discovery disputes, motions, answers, opening and closing statements, jury instructions, proposed facts and conclusions or law, proposed orders, conduct of the trial or audit, settlement negotiations, settlement conferences, and appeal activity.

The partnership agreement should address how to fund the audit, including after a liquidation of the partnership. The partnership agreement could allocate partnership audit expenses among all reviewed-year partners and adjustment-year partners, and address how the partnership will fund audit expenses and any imputed underpayment. Also important is partner cooperation with partnership audits. A partner otherwise may fail to provide needed information to the partnership during an audit.

A partnership agreement could merely provide that the partnership will elect out of the new partnership audit rules. The partnership agreement also may restrict transfers of partnership interests to qualifying partners who will permit an election out of the new partnership audit rules. Further, this agreement may provide for a partnership call on a transfer of a partnership interest not complying with requirements for permitted transferees, and even provide for forfeiture of the partnership interest transferred in defiance of partnership transfer restrictions. The partnership agreement should also require the partnership and the partner to cooperate with a partner under audit.
The proposed regulations on the new partnership audit rules may not appear for months. However, enough information is currently available that partnership agreement drafters can address partnership agreement provisions to govern partnership audits. Agreeing to these provisions well in advance of 2018 may make it easier for the partners to reach agreement than waiting until an IRS audit has been instituted.


5 These rules are contained in I.R.C. §§6221-35. These provisions were passed as part of the Bipartisan Budget Act of 2015 (H.R. 1315). These rules are based on earlier proposals by Ways and Means Committee Chairman Dave Camp included in the Tax Reform Act of 2014 (H.R. 1) and Senator Carl Levin included in the Partnership Auditing Fairness Act (S. 3018). Partnership audit reform proposals were included in the Partnership Audit Simplification Act (H.R. 2821) proposed by Representatives James B. Renacci (R-Ohio) and Ron Kind (D-Wisconsin).

7 These rules are contained in I.R.C. §§6221-35. The new partnership audit rules, found in I.R.C. §§6221-35, replace the prior rules under TEFRA found in I.R.C. §§6221-55. Citation to these I.R.C. sections are to the new partnership audit rules except as stated otherwise.

9 I.R.C. §6225(a).
10 I.R.C. §6223.
11 id.
12 id.
13 I.R.C. §6223(b)(1).
14 I.R.C. §6223(b)(2).
15 I.R.C. §6225.
16 I.R.C. §6221(b).
17 I.R.C. §§6221, 6225.
18 I.R.C. §§6221, 6225, 6226.
19 I.R.C. §6222(a).
20 The partner’s Schedule K-1 is an information return that the partnership gives the partner each year to report the partner’s distributive share of partnership income and loss.
21 I.R.C. §6222(b).
22 I.R.C. §6221(a).
23 I.R.C. §6225(b).
24 I.R.C. §6226(b)(1).
25 I.R.C. §6225.
26 I.R.C. §§6225, 6232.
27 I.R.C. §6225.
28 I.R.C. §§6225(c).
29 Id.
30 See id.
31 I.R.C. §6225(b)(2).
32 Id.
33 Treas. Reg. §1.704-1(b)(2)(iv), (3).
34 I.R.C. §6221(b).
36 I.R.C. §6231 (under TEFRA).
38 Treas. Reg. §301.6231(a)(1)-1(a)(1) (under TEFRA).
40 I.R.C. §6221(b)(1).
42 The partnership is required to furnish 100 or fewer statements under Section 6031(b) to its partners.
43 I.R.C. §6221(b)(1)(C).
44 See I.R.C. §6221(b)(2)(C).
45 I.R.C. §6221(b)(1)(D).
46 Id.
47 See I.R.C. §6226.
48 I.R.C. §6225.
49 I.R.C. §6225(b)(1).
50 I.R.C. §6225(a).
51 I.R.C. §6225(b).
52 I.R.C. §6225.
53 I.R.C. §6225(b).
54 I.R.C. §6225.
55 I.R.C. §6232.
56 I.R.C. §6225.
57 Id.
58 The new partnership audit rules do not address compensation of the partnership agreement.

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In the digital age, managing the public opinion aspects of legal disputes is integral to an overall litigation strategy.

**HOURS** after three people died in an Arizona sweat lodge, attorney Luis Li saw the news flash across the elevator video feed as he was riding to his 35th floor office at Munger, Tolles & Olson in downtown Los Angeles. By then, CNN, ABC, Dateline NBC, and the usual news outlets had gathered the available facts and produced a narrative that went viral on social media: the dead had been victims of a bizarre new-age ritual conducted by James Arthur Ray, identified in the stories as a new age cult leader.

That “cult leader”—a motivational speaker and New York Times bestselling author, who was featured in the 2006 documentary film *The Secret*—became Li’s client. For the next 18 months, as they prepared a legal defense, Li and his colleagues found themselves battling to neutralize a public narrative that—amplified through Facebook, Twitter and opinion-laced news websites—threatened to overwhelm their case and leave their client’s career and reputation forever ruined.

“High-stakes cases are often fought before a judge or jury and in the court of public opinion,” said Li, a former assistant U.S. attorney who specializes in white-collar defense and corporate crisis management. “To effectively advocate on behalf of a client—whether it is a business or an individual—lawyers must focus on winning both battles. And today, that court of public opinion is highly skewed by social media.”

As the Ray case illustrates, lawyers now, more than ever, have to factor in how the Internet and social media affect their clients long-term, as well as the case at hand. Never before has it been so easy to contaminate a jury pool, shame an opponent into settling a case, or discredit an opponent’s argument before court is called to order.

With judges, clerks, and potential jurors armed with smartphones, attorneys now find themselves in a courtroom without walls. Only in these halls of cyber “justice,” impressions prevail over arguments and instant karma trumps due process, making it more important than ever that attorneys engage and step up to represent clients in the court of public opinion, as well as in the court of law.

This also applies to lesser-known clients, who in the past may have escaped the scrutiny of traditional media. Today’s social media
Furies are notorious for plucking mere mortals from obscurity and ravaging them for real or perceived injustices.

Just ask Walter Palmer, who had enjoyed a quiet existence as a Minneapolis dentist and recreational hunter until he bagged Cecil the lion during an African safari last year. News of Cecil’s death exploded over the Internet and by the time a Zimbabwean court concluded three months later that Palmer did nothing illegal, it almost did not matter. The cyber mob had passed judgment, raining down death threats, destroying Palmer’s Yelp reviews with posts calling him a “disease” and “piece of filth,” driving him into hiding for weeks and harassing his family. 5 Palmer’s infamy was enshrined in a Wikipedia page dedicated to Cecil’s death. 6 It inspired a ban on the transport of hunting trophies by three major airlines, 7 calls by one congresswoman for a federal investigation, 8 the addition of the lion subspecies to the U.S. Endangered Species list, 9 and passage of a nonbinding resolution by the United Nations General Assembly calling for greater controls on illicit game hunting. 10

It also generated nasty telephone calls to his attorney, Joseph S. Friedberg, who has practiced law for more than 50 years. 11 “I can represent five baby killers and not get the kind of reaction I got from this,” he said, adding that the public fallout was so “incomprehensible” that even one local crisis communications specialist backed out of a promise to help “because the public relations would be bad for his PR firm.” 12

Friedberg said he stayed with the traditional advice of urging his client to keep quiet until the court of public opinion went on to another matter. “As much as it takes longer for the social media and Internet to calm down, and there’s an indelible record made, the foam goes away rapidly as soon as there’s another tragedy in the world,” said Friedberg, who regards the digital echo chamber as just another matter. “As much as it takes longer for the social media and Internet to calm down, and there’s an indelible record made, the foam goes away rapidly as soon as there’s another tragedy in the world,” said Friedberg. 13

It was Palmer himself who eventually demanded breaking the silence with a bit of remedial public relations. “He was quite concerned about his reputation and the people who knew him, loved him, and supported him—what they would think if he never said anything,” said Friedberg, who reluctantly helped his client find a fair-minded Minneapolis Star-Tribune reporter for Palmer’s only media availability. Even then, Friedberg permitted the interview to take place only when it became clear Palmer would face no criminal charges in the United States or Africa. Since his single media availability, the dentist has turned down “very, very friendly national TV interviews” and quietly returned to his practice, which Friedberg added, is thriving thanks to an influx of hunting sympathizers as new clients. 14

Friedberg’s blanket “no comment” policy long had been considered industry-best practices for attorneys, no matter the case. Then came Gentile v. State Bar of Nevada, 15 a watershed U.S. Supreme Court decision that first articulated the theory that a lawyer has a duty to protect his or her client’s reputation outside the courtroom.

The 1991 case involved a Las Vegas criminal defense attorney who called a press conference to denounce a pending indictment of his client for allegedly stealing drugs and $300,000 from a police safe. The attorney, Dominick Gentile, assembled reporters to say his client was a “scapegoat” and that the real culprits were “crooked cops.” 16 His client was acquitted at trial six months later, but the Nevada State Bar sanctioned Gentile for violating a Nevada Supreme Court rule against making extrajudicial statements that risked prejudicing a court proceeding. Gentile appealed. The Nevada Supreme Court upheld the ruling, but the U.S. Supreme Court reversed, finding Nevada’s rule unconstitutional. 17 In a powerful four-member minority opinion, 18 Justice Anthony Kennedy articulated a new standard for lawyers, writing:

An attorney’s duties do not begin inside the courtroom door. He or she cannot ignore the practical implications of a legal proceeding for the client. Just as an attorney may recommend a plea bargain or civil settlement to avoid the adverse consequences of a possible loss after trial, so too an attorney may take reasonable steps to defend a client’s reputation and reduce the adverse consequences of indictment, especially in the face of a prosecution deemed unjust or commenced with improper motives. A defense attorney may pursue lawful strategies to obtain dismissal of an indictment or reduction of charges, including an attempt to demonstrate in the court of public opinion that the client does not deserve to be tried. 19

In 1994, the American Bar Association followed suit. Rule 3.6 of its code of professional conduct had prohibited any out-of-court statements by counsel, fearing that any and all extrajudicial utterances might fan media coverage that compromised a defendant’s Sixth Amendment rights. 20 Following Gentile, the ABA amended the rule in two important ways. First, it narrowed the prohibition to apply only to those attorneys involved in the proceedings in question. Second, it allowed those attorneys the right to reply to correct negative publicity generated about their clients. 21

Conceived in a pre-TMZ era of relative media innocence, this compromise worked well as long as newspapers, television, and radio dominated legal coverage. Attorneys could go about their business, stepping outside their advocate role in court if and when they had to exercise damage control or correct the public record in high-profile cases. The O. J. Simpson case, however, raised the media stakes. 22 The slow-speed freeway chase of the white Ford Bronco marked the tabloidization of legal coverage. With it came the rise of a new class of talking heads—attorneys-turned-commentators. Daily coverage of the legal twists and turns stoked the public’s appetite for news about court cases, with trial reports delivering enormous ratings for newly launched 24-hour news channels and Court TV.

Then came Twitter, Facebook, TMZ, Wikipedia, Google, WordPress, YouTube, Bing, Myspace, Yelp, and Tumblr. New Web-based platforms and social networking channels began vying for public attention, challenging legacy media for dominance, and forever changing journalism—including even routine coverage of the law. What for decades was a fairly genteel, if somewhat tense, dance between lawyers and reporters devolved into the equivalent of a United Fighting Championship brawl—with the crowd pouring into the ring. With the cost of publishing reduced to the price of a cellphone, armies of bloggers and “citizen journalists” unleashed deluges of blogs and posts that mixed news with opinion, analysis with outrage. As satirist and political commentator Stephen Colbert wryly noted, the facts are no longer important in journalism: Truth was out, “truthiness” is in. 23

Social media also transformed news gathering from an inclusive process, in which reporters sought responses from all sides before submitting their stories to an iterative one with journalists racing to post short stories first, then adding details and quotes throughout the day. These various platforms tended to reward those who spoke quickly, not necessarily accurately. Mistakes, misquotes, and malevolent stories that once lasted a news cycle became enshrined forever in online search results.

These cultural and technological shifts have scrambled the news cycle, replacing it with a gusher of mashed-up “content.” Much of it is benign, such as cat videos, or enlightening, like cellphone videos of Arab Spring protests. Some of it, however, is dicey material that—amplified by Twitter, Facebook, and others—creates an instant scandal capable of bringing a reputable company to its knees. Washington-based crisis consultant Eric Dezenhall calls this the “glass jaw” effect,
similar to when a seemingly invincible fighter is knocked out by a sucker punch from a weaker opponent.24

A case in point is the Lennar Corporation, the nation’s second largest homebuilder. In January 2009, executives watched in horror as the stock price went into freefall after a San Diego outfit called the Fraud Discovery Institute issued a press release and two YouTube videos accusing the Fortune 500 firm of being a pyramid scheme riddled with Enron-like fraud.25 Within minutes, these fake “news bulletins” reached mainstream media, which quoted Lennar’s shocked CEO denying the rumors. But the narrative had been set, and within two weeks Lennar stockholders lost $500 million in value.26 Then there was the reputational carnage. As CEO Stuart Miller later told a Bloomberg Business reporter: “To our shock, all of the credibility we’d built over the years of our existence was in effect exercising mind control over our partners on the defense team faced a Yavapai County attorney who had lined up a cult expert to testify that James Arthur Ray was in effect exercising mind control over the three people who died during an October 2009 purification ritual at the conclusion of a “Spiritual Warrior” retreat. Ray was charged with three counts of reckless manslaughter and when he went to trial 18 months later, only one of the 350 potential jurors had not heard of the case.30 Half thought he was guilty of murder. The fact that half of the potential jurors did not, said Li, was attributable to a media “ground war” that he and his defense teammates ran to neutralize the cult-leader narrative. While Li spoke on background to reporters, Munger Tolles colleague Brad Brian appeared on CNN’s Larry King Live, and the team offered attendees of other Ray retreats for press interviews to create a more charitable view of their client.31

“Our main purpose was to show that Mr. Ray ran a business,” Li said. “He provided people with self-help advice and helped people accomplish things they couldn’t accomplish. And that’s not a cult....” Li said that by abusing people of the cult-leader narrative, the defense could put the case “in the world of a guy who ran an outdoor rafting company, a survival company, mountain climbing. Then he made a mistake. The trial is about how bad the mistake was, or about business risks, as opposed to a cult leader who killed his people.”32

In addition to front-ending the message, Li said the defense team monitored tweets and Facebook posts during the televised trial as a “feedback mechanism” to gauge how well the lawyers were making their points. “We read them (tweets and posts) because we wanted to know how audiences were perceiving what is being said,” Li said. “If a Tweet is capturing what our main point is, even if it is negative, at least they know what we’re fighting about.”33

In the end, the prosecution never called its cult expert, and the jury acquitted Ray of three counts of manslaughter, convicting him instead on the lesser charges of negligent homicide.34 Rather than the 37 years in prison the prosecutors had sought, Ray served less than two years in jail before he was released in March 2015.35 A year later, Ray began making a career comeback with a personal narrative that embraced his fall from grace as a transformative event—told on a website that also offered audio books, life coaching, and his services as a motivational speaker.36

With the complexities of today’s media landscape, some firms hire outside consultants to help shape the public narrative as part of the legal strategy. Similar to accountants and voir dire experts, consultants help plot, execute, and support litigation strategy through media relations. They work as part of the legal team by participating in brainstorming sessions, suggesting journalist-friendly language for court filings, preparing attorneys for press interviews, providing strategic advice for drafting media statements, working with reporters on background to explain legal procedure, and handling the logistics of issuing press releases and fielding reporter questions.

Attorneys for Martha Stewart hired a crisis public relations firm to help them battle the deluge of negative press when the homemaking diva faced a criminal indictment for securities fraud in 2003. Although Stewart ultimately was indicted and convicted, a federal judge found the public relations firm’s work served a legitimate litigation purpose because it tried to correct what Stewart’s lawyers described as the “unbalanced and often inaccurate press reports.” The PR “firm’s primary responsibility was to...neutralize the environment in a way that would enable prosecutors and regulators to make their decisions and exercise their discretion without undue influence from negative press coverage.”37 As a result, the judge agreed, in a “somewhat unprecedented” decision, that the vast majority of the firm’s work was protected under the attorney-client privilege and as attorney work product.38

The courts in other cases have protected the confidentiality of public relations work because the consultants acted as the functional equivalent of the client in their direct dealings with the attorneys and the press.39 Since then, some courts have chipped away at that protection, holding that such public relations tasks are within the privilege only if they “have a nexus with counsel’s representation.”40 To enhance the chance the court will see it that way, some attorneys advise hiring outside public relations consultants directly, and making sure that all correspondence, especially e-mail, is marked as confidential and goes through the law firm.41

Of course, few attorneys belong to law firms or represent clients with the resources to hire media consultants. They also don’t know how—or have the inclination or time during trial—to engage the mainstream media and activate social networks on a client’s behalf. This is not taught in law
school and, with so many diverse and often hostile options available for generating coverage, the possibility of failure is daunting. Yet given the mandate to promote the image and reputation of clients, as well as their legal claims, there are steps that even sole practitioners can and should take if there is even the slightest possibility of traditional or social media attacks.

Think worst case. Attorneys with major corporations or high-profile individuals as retainers should urge them to think frankly about their public relations vulnerabilities and draw up a crisis communications plan that will include decision trees, proposed holding statements, and steps for countering bad press as coverage unfolds. This needs to be done before a disgruntled former employee takes to Twitter or a New York Times investigative reporter leaves a message.

Pick your battles. Don’t react—respond. Part of crisis communications planning involves identifying the most strategic or important issues for a client or during litigation, and addressing those in the media pushback. Let the other issues go.

Write a holding statement. Often the initial media surge happens before a client can deliberate over a statement. An attorney should be prepared to step into breach and answer the first wave of questions from reporters, usually upon the disclosure of some allegation or the filing of a lawsuit. At the first inklings of trouble, attorneys should write a short holding statement of no more than three lines that 1) acknowledges the client is aware of the issue, crisis, or lawsuit and 2) is looking into the matter or is prepared to vigorously defend against the allegations. Then he or she should practice it—over and over—before tapping it to the phone. A holding statement like this serves a number of important purposes: 1) it avoids the temptation to reflexively issue a “no comment,” 2) it assures the client’s constituencies that it is paying attention and doing something constructive to address the problems, and 3) more practically, it gives the attorney on the media firing line a script to read—and stick to—until more becomes known.

Speak up—now. When it is necessary to speak up, it is important not to hesitate. It is imperative that attorneys get their clients’ side of the story into the first wave of blog posts or online stories. Otherwise, the attorney and client will miss the chance to shape the narrative up front so their storyline becomes part of the public conversation. Trying to change the narrative after that is extremely difficult, time-consuming, and expensive.

Write smartly. Court filings are still the best way for attorneys to make press statements, but reporters today are under tremen-

dous pressure to post immediately; they don’t have time to wade through paragraphs of turgid legalese to get the point. Clever attorneys make it easy for journalists by writing clearly and concisely, offering a narrative as an opening section and using headline-worthy phrases that will sum up arguments and prove irresistible to bloggers, commentators, and, truth be told, the judge. It’s easy to scorn “sound bites”—it is far wiser to use them.

One such example surfaced in the unsuccessful challenge of former Viacom CEO Sumner Redstone’s health directive brought by Manuela Herzer, his former girlfriend and confidante. In challenging Redstone’s mental capacity, her attorneys described the media mogul as a “living ghost,” a phrase that made headlines in Variety and The Guardian, and was repeated in more than 5,300 other stories, posts, and online news sites. The epigram launched a vicious power struggle within the company.

Get media training. Lawyers who write as if they are paid by the word need to take a dramatically different approach to media interviews, which get edited down to seven-second TV sound bites and a sentence or two in print. The interview subject needs to be prepared for likely questions and, above all, to be brief. The key to both is practice and more practice through media training from someone who knows, preferably from experience, what reporters will ask, what trick questions to avoid, and how to hone answers into phrases. A number of former journalists and media firms provide media training. A Google search of media training in Los Angeles will turn up names.

Use social media as feedback. Once an attorney or client engages in the court of public opinion, monitoring how it appears on news websites and social media is helpful, especially after filing an important brief or making a court appearance. Instead of looking for approval, the attorney should see if even the detractors are getting the point.

Best face forward. Consider that the lead lawyer on the litigation team might not be the best talking head. What makes someone great at verbal judo in the courtroom may doom him or her before the cameras. If the attorney has the luxury or is not a sole practitioner, it is best to pick a member of the legal team who is photogenic, articulate, passionate, and speaks succinctly. Since all that matters is what is best for the client, it is imperative not to be shy about appointing a junior member of the team to face the microphones.

Fight hard for corrections. Gone are the days when embarrassing stories or reporting mistakes lasted only a day before heading to the bottom of the birdcage. Now, bad journalism lives forever on the Internet, available for every reporter to find and repeat in subsequent stories. This means attorneys and their media consultants must adopt a “won’t-take-no-for-an-answer” policy to get a correction or clarification, which then will be appended to the online story, casting doubt on the original reporting.

Know when to hold ‘em. Being media savvy also means knowing when to dodge the spotlight. This is especially true when settlement or plea-bargain discussions, which might have been spurred by public pressure, reach a delicate stage. Such was the case with a Los Angeles grade school teacher who was charged with multiple counts of lewd conduct, making him one of the most reviled figures in the community. From the beginning, a plea disposition appeared to be a viable option but it required lengthy and substantive plea negotiations with the district attorney’s office.

Had word leaked out—even unintentionally—those discussions would have collapsed, so both sides kept mum until a plea deal was reached that was acceptable to the client and the prosecutor.

These are basic tools that attorneys need as they grapple with how the Internet and social media have created a sea change in the way legal news is generated, covered, and received. The legal system no longer lives in a bubble. Attorneys who do not try to harness the new media as part of a litigation strategy are not only shortchanging their clients, they are hurting themselves.

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1 Interviews with attorney Luis Li, Partner, Munger, Tolles & Olson LLP. (July 7 and Sept. 14, 2016) [hereinafter Li].
3 Li interviews, supra note 1.
4 Id.
7 Cummings, supra note 5.
12 Id.
13 Id.
14 Id.
16 Id. at 1034.  
17 Id. at 1033-34.  
18 See id. at 1032, 1037-1048.  
19 Id. at 1043.  
20 ABA Model Rules of Prof'l Conduct R. 3.6.  
26 Id.  
27 Id.  
30 Li interviews, supra note 1; see also State v. Ray, No. V-1300-CR-201080049 (Yavapi Super. Ct. 2011), available at http://courts.yavapai.us/supiorcourt. Click on “case information” and provide the case number or defendant’s name, James Arthur Ray.  
31 Li interviews, supra note 1.  
32 Id.  
33 Id.  
35 Li interviews, supra note 1.  
38 Id. at 332. See also Michael Jay Hartman, No Amber-Teach Us About the Constitution: Why Constitutional Considerations Warrant an Extension of the Attorney-Client Privilege in High-Profile Criminal Cases, 10 JOURNAL OF CONSTITUTIONAL LAW 867, 868-69 (May 2008)[hereinafter Hartman].  
41 Fenton & Garcia, supra note 39.  
43 Thielman, supra note 42.
Statutory Transcription Rates Do Not Apply to Private Court Reporters

TO COPE WITH THE UNPRECEDENTED budget cuts beginning in 2008, some California courts, including Los Angeles, have limited the availability of official reporters for civil proceedings. In these courts, parties are free to arrange for private reporters as long as the reporters are appointed as “official reporters pro tempore.” Unlike official reporters employed by the court, official reporters pro tempore do not receive employment benefits such as paid time off or health insurance. Their compensation is generally limited to appearance and transcript fees.

In May 2014, attorney Tara Burd filed a class action complaint against Barkley Court Reporters alleging violations of Government Code Sections 69950 (Transcription Fees) and 69954 (Transcripts Prepared with Computer Assistance Fees), which limit the transcription rates that official reporters may charge. Burd contended that these sections are not limited to official reporters but also apply to private court reporters or official reporters pro tempore, such as the Barkley court reporters she hired.

In January 2016, Los Angeles Superior Court Judge Amy D. Hogue rejected Burd’s arguments and granted Barkley’s motion for judgment on the pleadings. The court noted that Article 9 of the Government Code was enacted when the courts were fully staffed with salaried court reporters. The provisions, when written, did not anticipate that salaried court reporters would be eliminated and replaced by private reporters hired by litigants on a case-by-case basis. Nevertheless, a plain reading of Article 9 indicates that the statutory rates govern only court reporters employed by the courts.

Section 69947, which governs the fees set forth in Sections 69950 and 69954, states that “the official reporter shall receive for his services the fees prescribed in this article.” By referring only to the official reporter, the legislature intended for the statutory fee provisions to apply only to salaried official reporters and not to private reporters pro tempore. In coming to this conclusion, the court recited six sections of Article 9 that distinguished between official reporters and official reporters pro tempore, observing that “[t]he use of these two distinct terms indicates that the Legislature intentionally used the term ‘official reporter pro tempore’ to distinguish privately employed court reporters appointed pro tempore from official reporters employed by the court.”

The court also rejected the plaintiff’s argument that California Rule of Court 8.130 is rendered ineffective if Sections 69950 and 69954 do not apply to official reporters pro tempore. Rule 8.130 governs the filing of reporters’ transcripts on appeals. Among other things, it provides that when a transcript is completed, a reporter must bill each party at the statutory rate. However, this rule also provides for the court of appeal, on its own or the respondent’s motion, to order the record augmented to include the transcript and makes the appellant responsible for its costs. Such a rule, therefore, reasonably sets a cap for transcripts that may be compulsory. The court stated that it “does not follow, from this rule, that the Legislature intended to regulate rates for all transcripts prepared by pro tempore reporters in the trial courts ordered by the respective parties to the proceedings.” Finally, the court rejected the plaintiff’s argument that public policy supports regulating the transcription rates of private court reporting firms. Unlike criminal cases, civil litigants do not have a constitutional, statutory, or common law right to court reporting services. Further, the Rules of Court provide for alternative procedures for making a record for appeal. The court expressed concern that government regulation of private court reporting firms “compromises strong countervailing public policies favoring free enterprise and com-

Article 9 of the Government Code was enacted when the courts were fully staffed with salaried court reporters.

3 GOV’T CODE §§69947, 69950, 69954.
4 See Klein v. United States, 50 Cal. 4th 68, 80 (2010).
5 See GOV’T CODE §§69941, 6944, 69946, 69952(b), 6955(a), 69957.
7 CAL. R. CT. 8.130(f)(2). The Advisory Committee Comments provide that “[t]he fee for reporter’s transcripts are established by Government Code sections 69950 and 69554.”
8 CAL. R. CT. 8.130(a)(4).
9 See Order, supra note 5, at 9.
10 See LASC Policy, supra note 1.
11 See CAL. R. CT. 8.133, 8.137.
12 See Order, supra note 5, at 10.

Jeffrey Huron, Phu Nguyen, and Jyoti Avila practice business and real estate litigation in the Los Angeles office of Dykema Gossett LLP. They, together with Marc Allaria of Litchfield Cavo LLP, represented Barkley Court Reporters in Tara R. Burd v. Barkley Court Reporters, Inc.
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