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IN THIS ISSUE

So You Want to Start a CryptoFund?: Contemplating Risk Factors to Include in Your Private Placement Memorandum

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With 2017 ("The Year of Crypto") in the rearview, business owners, financial advisors, estate planners, legislators, and any individual in regular contact with a millennial is likely asking this progression of questions: "What is Bitcoin? Is it a fraud? How can I invest in cryptocurrencies? How can I invest other people's money in cryptocurrencies?" This article will largely focus on the final question, paying particular attention to unique risk factors that should be included in a cryptofund's Private Placement Memorandum.

However, briefly addressing the first three questions: (1) Bitcoin is a digital "cryptocurrency" that relies on encryption techniques—namely "cryptographic hashing functions"—to regulate and generate units of value, to verify the transfer of funds, and to run a "trustless" and decentralized ledger that tracks account balances without any support from banking institutions; (2) Bitcoin has been called a "fraud" by JPMorgan Chase's CEO, Jamie Dimon, and a legitimate "store of value" by the Winklevoss twins (the controversial co-creators of Facebook), the debate is still ripe; (3) Buying Bitcoin and alternative cryptocurrencies is as easy as downloading an application on your phone (Coinbase, Robinhood, Poloniex, etc.), linking your bank account, and executing a buy order.

Now, imagine that you have been investing in cryptocurrencies for a year or more, have realized impressive gains, and are ready to start a hedge fund trading exclusively in cryptocurrencies. You are going to need to draft four critical documents: (1) A Company Agreement for the Manager (i.e. "Kirkham Capital, LLC"), (2) a Company Agreement for the Fund (i.e. "Kirkham Fund, LLC"), (3) a Subscription Agreement (including an "Accredited Investor Questionnaire"), and (4) a Private Placement Memorandum ("PPM") describing the investment and disclaiming all contingencies. Drafting a bulletproof PPM that discloses all possible litigious contingencies is critical.

I have identified three categories of risks unique to cryptofunds that ought to be addressed in any fledgling cryptofund's PPM.

(1) UNFORESEEN REGULATORY RISKS

Unforeseen regulatory risks are perhaps the most important category of disclaimers because regulation of cryptocurrencies is imminent, but the scope, the promulgating

continued on page 2

Bankruptcy Attorney Michelle V. Larson Joins Carrington Coleman

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Noted bankruptcy attorney Michelle Vonsenden Larson has joined the Dallas office of Carrington, Coleman, Sloman & Blumenthal, LLP, as an insolvency and reorganization practice partner.

She represents a diverse range of clients and brings significant experience in complex, sophisticated bankruptcy matters that will greatly benefit Carrington Coleman.

To learn more about Ms. Larson, please visit our web site at www.ccsb.com/attorneys/larson-michelle-v/

continued from page 1 - So You Want to Start a CryptoFund?

agency, and the impact on your cryptofund remain uncertain. These disclaimers should not only contemplate changes in securities law—perhaps the most direct impact on your ability to manage a cryptofund—but should contemplate changes in tax law and commodities law.

A few examples:

- Adverse regulatory, tax, and legal changes could occur during the fund's operation that could negatively affect the fund's investment or business models.
- Adverse regulation could compromise the legality of the fund and could result in legal or tax liability to the fund's manager and/or the fund's investors.
- It may become illegal to buy, sell, or hold virtual currencies.
- The fund may be negatively affected by unforeseen regulation requiring the fund's manager to register the fund or otherwise satisfy burdensome reporting requirements.
- The fund may be required to disgorge digital assets currently under management in order to comply with unforeseen regulation.
- No assurances can be made about future regulatory schemes and their impact on the fund or the fund's assets.

(2) CRYPTOCURRENCIES ARE SPECULATIVE IN VALUE

While there is debate about the inherent value of cryptocurrencies, your mission is to minimize risk by accepting and disclosing that the cryptocurrency market is—at least in part—driven by speculation.

Here is an idea of how:

- The fund invests in speculative tokenized assets that pose a substantial risk of total loss of value.
- There is no assurance that tokenized assets will maintain their short-term or long-term value.
- Tokenized assets held by the fund may have no inherent value and may increase or decrease in value purely based on speculation in the market.
- INVESTMENT IN VIRTUAL CURRENCIES IS SPECULATIVE. (intentionally capitalized)

(3) LACK OF LIQUIDITY

Lack of liquidity is an essential disclosure. Cryptofunds are especially vulnerable to liquidity squeezes for two reasons: (1) some of the fund's assets will likely be stored "cold"—on hardware wallets—separated from the immediate liquidity of exchanges and (2) exchanges only facilitate the purchase and sale of select tokens.

Cold storage is undoubtedly the safest way to store tokenized assets. On a hardware wallet (a souped-up thumb drive), assets are generally safe from hackers, exchange crashes, exchange glitches, or a meltdown of the protocol. In fact the only major draw back is the reduced transaction speed. Simply put, if the market for a particular token begins to crash, the fund manager will have to transfer assets from "cold storage" to an online exchange and will have to wait for that initial transaction to clear, before finally being able to sell the assets. This additional step can limit an asset's immediate liquidity and subject the fund to a loss.

Similarly, exchanges only support the purchase and sale of select cryptocurrencies. For this reason, the liquidity of certain tokens might be limited depending on the proper functioning of supportive exchanges. For instance, if the only exchange facilitating the purchase and sale of "Token X" goes offline, the fund may be adversely impacted by the sudden inability to sell "Token X." This counterparty risk necessitates disclosures about the fund's reliance on exchanges to buy and sell cryptocurrencies.

Examples include:

- The fund stores tokenized assets on hardware wallets, limiting the fund's ability to immediately sell tokenized assets.
- The fund may be negatively affected by a lack of immediate liquidity due to the fund's current or future custodianship of tokenized assets.
- The fund is reliant on third party exchanges to buy and sell tokenized assets and is therefore subject to liquidity squeezes in the event that a particular exchange is temporarily inaccessible.

> The market for cryptocurrencies is rapidly changing, presenting huge opportunities for investors, and in turn, investment managers.

The market for cryptocurrencies is rapidly changing, presenting huge opportunities for investors, and in turn, investment managers. But, individuals looking to capitalize on the inefficiencies of the market by offering interests in actively managed hedge funds need to be wary of and disclose the associated risk. The above is just a start, a way to get cryptofund managers thinking long and hard about the immediate risks, unforeseen risks, and those risks currently treated as immaterial. ■

The Qualified Business Income Pass-Thru Deduction as Passed by the Tax Cuts and Jobs Act

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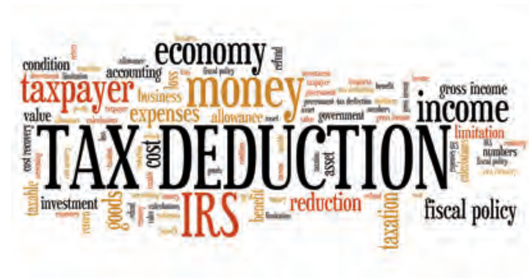
What is it? Under new Section 199A of the Code, certain non-corporate taxpayers are entitled to a tax deduction equal to as much as 20% of their qualified business income. That's about all that is easy to understand about Section 199A. It is available to owners of partnerships and S corps, but also to sole proprietors, so in that sense, it is not a pass-thru deduction. It is a below the line deduction, so it does not reduce the taxpayer's adjusted gross income, but can be taken whether or not the taxpayer itemizes. It is limited to the taxpayer's taxable income, so losses from other businesses may affect the ability to take the deduction and losses from a qualified business have to be carried forward and may reduce qualified business income in future years.

Who can take it? Generally, any trade or business, other than the business of being an employee, can generate qualified business income, so the owner(s) of that business may be entitled to a deduction related to the business's qualified business income, which excludes certain types of income that do not relate to the business, such as interest and dividends. However, above the Threshold Amount (discussed below), special rules apply to exclude all income from specified service trades or businesses, including health, law, accounting, investments, consulting, performing arts and athletics, or other trades or businesses where the principal asset of the trade or business is the reputation or skill of one or more of its employees. There are also limitations on other types of businesses where an owner of that business has taxable income in excess of the Threshold Amount.

What is the Threshold Amount? The Threshold Amount of taxable income of the trade or business owner for maximum deduction is $157,500 (or $315,000, if filing jointly). That amount will be adjusted in the future for inflation. Taxable income amounts above the Threshold Amount and below $207,500 ($415,000, if filing jointly) (whichever applies is herein referred to as the "Cap") are entitled to a pro-rated deduction and are technically within the Threshold Amount. The Threshold Amount is tested at the individual partner or shareholder level. As a result, some partners and S corporation shareholders may be entitled to some or all of the deduction and others may not. Guaranteed payments to partners and reasonable compensation to S corporation shareholders are not considered qualified business income, so how a partner or shareholder receives income from the business may also impact their ability to take the deduction.



What if your taxable income exceeds the Cap? If the business you own is engaged in one of the specified service trades or businesses, you will not get a deduction related to your income from that business if your taxable income exceeds the Cap. With respect to other businesses, if taxable income is above the Cap, the amount you can deduct is limited by the payroll and depreciable assets of the business. It is the lesser of a) 20% of taxpayer's qualified business income or b) the greater of i) 50% of the W-2 wages of the business or ii) the sum of 25% of the W-2 wages of the business plus 2.5% of the unadjusted basis immediately after acquisition of qualified property, which is generally depreciable property that has not been fully depreciated.

Should you change the form of your business? Each individual trade or business will need to analyze its tax situation to see if another form of business may be advantageous. There is no simple formula or guide to determine whether or not a pass-thru or a C corporation will be more beneficial to the taxpayer. This discussion is necessarily brief and does not cover all of the provisions of Section 199A. You should discuss your specific situation with your tax advisor to determine whether or not any changes to your business operation could improve your tax situation. ■

Carrington Coleman Welcomes Two New Associates

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New IRS Audit Rules Affect Partnerships, LLCs, and S Corporations

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New rules that took effect on January 1, 2018 replaced existing rules for IRS audits of entities classified as partnerships for federal income tax purposes. Such entities include not only partnerships, but also limited liability companies and S corporations. In this article, all such entities are referred to as partnerships and their owners are referred to as partners. Though the rules have only recently become effective, they were passed as part of the Bipartisan Budget Act of 2015.

Under the prior rules, partnership audits were unified proceedings in which the entity's "tax matters partner" (TMP) was in charge of coordinating the audit and any judicial proceedings that took place in connection with it. The IRS was generally required to issue notice of the audit to all partners, each of whom had the right to participate in the audit or judicial proceedings and to negotiate a settlement directly with the IRS. An audit ended when the IRS mailed to the TMP and to each partner who had not settled with the IRS a notice of Final Partnership Administrative Adjustment (FPAA). Partners could challenge the IRS's findings in court, even if the TMP chose not to do so. The IRS had one year after the issuance of the FPAA to audit and collect taxes from the various partners.

Under the new rules, the IRS can audit partnerships at the entity level and require the entity to pay the imputed underpayment, which is determined using the highest individual or corporate rate of tax. Upon completion of the audit, the IRS will send a "notice of proposed partnership adjustment," after which the entity will have 270 days to seek adjustments. Upon receipt of the final audit adjustment notice, the entity will have 45 days to elect out of the entity-level tax and 90 days to petition for a readjustment. To elect out of the entity-level tax, the entity must furnish each partner with a statement of the partner's share of the adjustment, and the partners will be responsible for paying their respective shares of the assessed tax. If the entity makes this election, interest on the imputed underpayment increases from 3% to 5%. The entity owners will be bound by the adjustments shown on the statements they receive; there is no provision for administrative or judicial recourse for partners.

In addition to changing the procedure for audits of partnerships, the new rules also change how the entities are represented in the audit process. The TMP is replaced by the "partnership representative" (PR). Whereas the TMP had to be an owner of the entity it represented, the PR need not be, though he, she, or it must have a "substantial presence" in the United States. If the PR is an entity, there must be a designated individual through whom the PR will act. Perhaps most importantly, while the TMP could bind the partnership, it could not bind any partner with regard to audit results. The PR, however, has sole authority to bind the partnership. The partnership and all of its partners will be bound by the decisions the PR makes in the audit proceedings. If an entity failed to designate a TMP for a particular year, that role would fall to the partner with the largest profits interest at the close of the taxable year. If an entity fails to designate a PR, the IRS may select "any person" to fill the vacancy.

> In light of the new audit rules, partnerships, limited liability companies, and S corporations should consider revisiting their governing documents.

Certain entities will be able to opt out of the new rules. Opting out is available if the entity has not more than 100 owners, each of whom is an "eligible partner." An eligible partner is an individual, a C corporation, an S corporation, an estate of a decedent, and certain foreign entities. If any owner of an entity is a disregarded entity, a partnership, a limited liability company, a trust, or an ineligible foreign entity, it cannot opt out of the new rules. If an entity is able to opt out, it must make an annual election to do so and must provide the name, tax identification number, and tax classification of each owner. The partnership must notify each partner of the election within 30 days. If an entity is eligible to opt out and properly elects to do so, the IRS cannot audit the entity in a unified proceeding. Instead, it must initiate audits of each partner and will be able to collect the assessed tax from such partners.

In light of the new audit rules, partnerships, limited liability companies, and S corporations should consider revisiting their governing documents. Such entities will want to make sure that their governing documents address, for example, how the PR is chosen and provide that the entity have a PR at all times. Partners may want to require in the governing documents that the PR give all partners notice of an audit and should consider whether the PR must put audit matters to a vote of the partnership. In addition, because an audit assessment may relate to a prior year in which ownership of the partnership was different, governing documents should require all partners to be liable for audit assessments for their years of ownership, even after they have left the partnership. ■

Secured Creditors Beware: Don't Think You Can "Ride Through" a Bankruptcy Unaffected

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Amendments to the Federal Rules of Bankruptcy Procedure became effective on December 1, 2017, which impose affirmative obligations on secured creditors to protect their rights to distributions in a bankruptcy case. Previously, Bankruptcy Rule 3002(a) required only unsecured creditors and equity security holders to file proofs of claim or proofs of interest in a bankruptcy. Although often recommended, it was not statutorily necessary for a secured creditor to file a proof of claim in order to protect its rights. Newly amended Bankruptcy Rule 3002(a) effects a marked change in the law and affirmatively requires a secured creditor to file a proof of claim in order for its secured claim to be allowed in a bankruptcy.

Two additional amendments to Bankruptcy Rule 3002, which are intended to expedite the resolution of bankruptcy cases, are worth noting for secured and unsecured creditors.

Ignoring this new requirement may lead to a secured claim not being allowed in the bankruptcy (unless such claim is included on a debtor's schedule of liabilities or is otherwise allowed by Bankruptcy Court order). Nevertheless, consistent with Section 506(d) of the Bankruptcy Code, Bankruptcy Rule 3002(a) has also codified prior bankruptcy case law to clarify that a secured creditor's failure to file a proof of claim will not alone lead to the underlying lien securing the claim being voided.

Two additional amendments to Bankruptcy Rule 3002, which are intended to expedite the resolution of bankruptcy cases, are worth noting for secured and unsecured creditors.

1. Bankruptcy Rule 3002(c) has been amended to shorten certain deadlines or "bar dates" applicable to the filing of proofs of claim. New Bankruptcy Rule 3002(c) shortens the deadlines for filing a proof of claim in a voluntary Chapter 7 (liquidation for companies or individuals), Chapter 12 (reorganization for a family farmer or fisherman), and Chapter 13 (reorganization for individuals) case to not later than 70 days after entry of the order for relief (or the date of the order of conversion to a Chapter 12 or Chapter 13 case). In most jurisdictions, this typically means that proofs of claim must be filed no later than 70 days after the bankruptcy petition is filed. In an involuntary Chapter 7 case, proofs of claim must be filed no later than 90 days after the entry of the order for relief under amended Bankruptcy Rule 3002(c), rather than 90 days after the "first date set for the meeting of creditors" (under the prior version of the Rule).

2. Bankruptcy Rule 3002(c)(6) has been amended to grant a creditor relief from the bar date if a creditor in a Chapter 7, Chapter 12, or Chapter 13 case failed to receive sufficient notice of the filing of the bankruptcy case. Under new Bankruptcy Rule 3002(c)(6), upon a creditor's motion, the Bankruptcy Court may extend the time for filing a proof of claim for not more than 60 days following an order granting the creditor's motion for an extension of time. In order to be granted additional time, a creditor must show that: (a) the debtor failed to file its list of creditors under Bankruptcy Rule 1007(a) timely, or (b) the notice was insufficient to provide the creditor with a reasonable time to file a proof of claim, because the notice was mailed to a foreign address. Rule 3002(c)(6) does not define "foreign address". It is likely that new subsection 3002(c)(6) will be utilized by creditors who fail to receive notice of the bankruptcy case because they were left off of the debtor's schedules of liabilities or were listed in the schedules, but at the wrong address.

If you have any questions concerning these amendments or any other bankruptcy matters, please contact Michelle Larson (214-855-3130 or mlarson@ccsb.com) or J. Michael Sutherland (214.855.3069 or msutherland@ccsb.com). ■

WHAT LEGAL ISSUES ARE IMPORTANT TO YOU?

Let us know what legal topics you would like to read about in the next issue of the Capital Newsletter. We want to know what's on your mind.

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Advantages of NFA Gun Trusts - And the Need for Custom Drafting

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Are you interested in legally having access to Title II firearms and also being able to legally provide access to such Title II firearms to other trusted family members (or even trusted friends)? If so, an "NFA Gun Trust" may be the right choice for you.

"Title II firearms" include, among others, short barreled rifles and shotguns, suppressors and silencers, as well as other less commonly owned devices.[1]

Under the National Firearms Act ("NFA"), a "person" cannot legally possess a Title II firearm unless such "person" is the registered owner of such firearm.[2] Any illegal possession of a Title II firearm is punishable by up to 10 years in prison and a $10,000.00 fine[3], with the firearm being subject to forfeiture.[4]

Fortunately, for purposes of the NFA, a "person" is not only an individual, but can also be a trust (as well as a partnership, an association, a company, or a corporation).[5]

Although recent regulations promulgated by the Bureau of Alcohol, Tobacco, Firearms and Explosives under ATF Regulation 41F (which became effective July 13, 2016)[6] increased the burdens of registering ownership of Title II firearms to trusts, the most burdensome being required background checks for all "responsible persons" (who are those with rights to make major decisions or possess Title II firearms), there are still various advantages to establishing NFA Gun Trusts.

One primary advantage of such a trust is that more than one individual (so long as these individuals are not generally prohibited by applicable federal and state law from possessing and/or accessing firearms) can lawfully possess and/or access the Type II firearms that are registered to the trust.

Another important advantage of establishing an NFA Gun Trust is that the trust, if drafted properly, can allow for the Type II firearms registered in the name of the trust to continue to be owned by the trust even after the original grantor(s) and trustee(s) of the trust pass away. The use and control of these Type II firearms, as well as the beneficiaries who will ultimately be distributed these firearms, can thus be established and continue to be governed by the NFA Gun Trust in perpetuity. Should it ever become illegal to transfer Type II firearms due to a change in the legal landscape, the true benefit of this advantage of "continuity" will be realized.

Given the serious risk of criminal prosecution for illegal possession of Type II firearms, it is imperative that NFA Gun Trusts are drafted properly with adequate thought, deliberation, and consideration. To properly implement an NFA Gun Trust, you should work with your attorney to understand and properly achieve your intended result. For example, some considerations which you may wish to address include: (i) the individuals who will be given access to the Type II firearms to be owned by the trust, (ii) whether there are risks associated with providing such individuals access, (iii) whether you as the creator of the trust will have more rights to the trust firearms (such as the right to sell) than the other individuals who you may wish to only have access to the trust firearms, and (iv) who are the ultimate beneficiaries to be distributed the firearms once the trust terminates.

To prevent taking action that would violate applicable law, adequate instructions, warnings, and specific requirements and procedures on how to legally handle, possess and transfer Type II firearms should also be properly noted in the trust documentation, for the benefit of both the initial trustee(s) and subsequent successor trustee(s) of the trust, as well as the beneficiaries of the trust. Of course, as an NFA Gun Trust is also an estate planning tool and can be used to own any firearm, whether Type II or not, adequate consideration also needs to be given to your overall estate planning needs.

NFA Gun Trusts can be a valuable tool if you are interested in Type II firearms. As the risks of using an improperly or inadequately drafted NFA Gun Trust are potentially severe (including criminal prosecution), appropriate consideration should be given by you and your attorney in discussing, drafting and implementing your NFA Gun Trust. ■

1. 26 U.S.C. § 5845.
2. *Id.* § 5861.
3. *Id.* § 5871.
4. *Id.* § 5872(a).
5. 26 U.S.C. § 7701(a)(1).
6. *See* Final Rule 41F (AG Order No. 3608-2016).