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Amazon Laws: An Idea Better in Theory Than in Practice

It is obvious that the internet revolutionized the way many companies do business. Alongside the explosive growth of the internet, many new business models developed.

As business models progress, state laws have become ever more complex and the bright line test of nexus becomes blurred. Currently, internet sales are the target of many state taxing authorities, particularly with the growing pressure on state budget deficits.

Many online retailers do not collect sales taxes in all states to which goods are shipped, presumably because of their lack of physical presence in those states. Amazon, the largest online retailer in the United States, is no exception. Amazon's business model uses an affiliate program to generate business. The affiliates are independently operated websites that post ads with links to Amazon.com. In return, Amazon pays the affiliate a percentage of each sale that is generated by the ad or link.

New York was the first state to assert a sales tax collection responsibility on this internet business model. In April 2008, the state enacted legislation that created a presumption that a retailer solicits business in the state “if the seller enters into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an internet website or otherwise, to the seller.” This new legislation, dubbed the “Amazon law,” created a requirement for online retailers to begin collecting sales tax from their New York customers. Amazon and Overstock, another online retailing giant, brought a lawsuit against New York to overturn the new law; however, the suit was dismissed in January 2009. Amazon and Overstock appealed the dismissal, and in November 2010, the Appellate Division of the New York Supreme Court revived some (but not all) of the claims by Amazon and Overstock that the statute is unconstitutional. Specifically, the Appellate Division held that the Amazon law does not violate the Due Process Clause, Commerce Clause, or the Equal Protection Clause on its face. However, the Appellate Division reinstated the cases to determine whether the statute violates the Due Process Clause and Commerce Clause as applied to Amazon and Overstock.

Colorado also adopted an Amazon law. Initially, Colorado’s legislation was identical to the law in New York, but lawmakers feared backlash from online retailers for requiring them to collect sales tax. As a result, Colorado gave online retailers an option to either collect sales tax voluntarily or notify all customers of their use tax liability at the end of the year.

Oklahoma imposed a watered down version of the law. Online retailers are only required to post a customer’s use tax responsibility on their websites. Sales tax is not required to be collected, nor is there any additional reporting required, as is the case with the New York and Colorado laws. However, the Oklahoma law has a much larger reach; it applies to a much wider group of internet sellers than does either the New York or Colorado Amazon laws.

Illinois is the most recent state to take action against online retailers. On January 6, 2011, the Illinois General Assembly passed House Bill 3659. This bill would revise the state’s definition of a “retailer maintaining a place of business in the state” to include retailers who pay commissions or other consideration to persons in the state for referring potential customers to the retailer by a link on the person’s internet website. If signed by the governor, the law will become effective July 1, 2011. The Illinois proposal would require any retailer with a single internet affiliate operating in the state to collect sales tax.

What does all of this mean for businesses that sell via the internet? It is clear that states are taking this issue very seriously and many states are following New York’s lead. In terms of competition, it is possible that online companies could cancel their affiliate programs in the states that adopt Amazon laws. In addition, the growing expansion of these Amazon laws creates a challenge for new and small businesses planning to expand and market themselves throughout the country. Moreover, many commentators believe that these laws do not have the intended effect of increasing revenue. The Tax Foundation, a nonpartisan educational organization, found that, at least in the short term, the passage of these laws may actually lead to a tax decrease. That is, when Amazon pulled the plug on its affiliate programs in Rhode Island, Colorado, and Connecticut these states actually experienced a decrease in personal income tax revenue that more than offset any gains seen on the sales tax side. Furthermore, the theory that these laws will “level the playing field” between "brick and mortar" stores and online retailers is also flawed. Online retailers must track sales from all 50 states whereas "brick and mortar" stores need only track sales for one state. This additional compliance burden results in additional costs incurred by online retailers.

In the end, only time will tell whether these Amazon laws will actually achieve the goal of generating revenue in

states with budget shortfalls. However, it doesn't appear as though the states are willing to wait and many would rather enact an Amazon law now in an attempt to generate revenue as soon as possible. For that matter, there is even a possibility that some states could attempt to further expand their nexus rules to other business models such as television advertisements and infomercials. What remains clear is that taxpayers are not taking the Amazon laws lightly and the business environment, along with the state tax laws applicable to online retailers, will continue to change in the future.

Just days before this article went to press, Amazon announced it will close one of its distribution centers in Texas and cancel all plans to expand operations in the state as the result of a dispute with the Texas Comptroller over millions of dollars of uncollected sales tax. In an effort to prevent the loss of local jobs and millions of investment dollars, Governor Perry is looking to get the legislature involved to keep Amazon in Texas, but it may already be too late. Although Amazon's dispute with Texas was not the result of an "Amazon law" passed by the state, Texas is asserting that Amazon owes sales tax as a result of the Texas distribution center operated by an Amazon affiliate. It still underscores how serious the various states are taking this issue and the potential economic ramifications that these decisions could have on their local economies.

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Will Your Family Office or Private Fund Be Exempt from SEC Registration?

As previously discussed in our July 2010 newsletter article, the Dodd-Frank Wall Street Reform and Consumer Protection Act requires managers of large hedge funds, private equity funds, and multi-family offices to register with the Security and Exchange Commission (SEC) as investment advisors.

The SEC recently proposed rules to implement registration exemptions for smaller funds, venture capital funds of any size, and single family offices. While those who qualify for these exemptions get relief from registration, they may not entirely escape increased regulation.

Registration for Large Private Funds

On July 21, 2011, managers who advise private investment funds of $150 million or more in aggregate will have to register with the SEC as investment advisors. A “private fund” would include a pooled investment vehicle exempt from registration as an investment company based on the so-called 3c-1 or 3c-7 exemptions under the Investment Company Act of 1940. In addition to typical hedge funds and private equity funds, the proposed rules would also treat many real estate funds, liquidity funds, and securitized asset funds as private funds.

When calculating assets under management for the $150 million threshold test, the proposed rules would require use of the fair value method. Among other items, uncalled committed capital and assets of non-U.S. investors must also be included.

Exemption for Smaller Private Fund Advisors

Managers of one or more private funds totaling less than $150 million are exempt from federal registration as investment advisors and the full slate of regulations that would ensue. Despite this registration exemption, these so-called "exempt reporting advisors" will nevertheless be subject to SEC examination and recordkeeping requirements. Periodically, exempt reporting advisors would also publicly disclose their basic background information, such as their related business activities, fund organization and characteristics, and disciplinary history beginning on August 20, 2011. Many of these exempt reporting advisors would be required to register at the state level. However, many states are likely to adopt regulations mirroring the federal exempt reporting advisor requirements. The private fund exemption would not be available to a manager who also advises clients other than private funds. Instead, the manager would register either at the federal or state level depending whether assets under management are over, or under, $100 million.

Exemption for Venture Capital Fund Advisors

Managers who solely advise venture capital companies are exempt from SEC registration regardless of the amount of assets under management. Like the smaller private fund advisors, venture capital company managers would be deemed exempt reporting advisors subject to SEC examination, reporting, and recordkeeping requirements and possibly state registration as described above.

The proposed rules define a "venture capital company" as a private fund that:

- invests only in equity securities of private "qualifying portfolio companies" to provide operating and business expansion capital (i.e., not to recapitalize the portfolio company);
- directly, or through its investment advisors, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company (i.e., not a hedge fund);
- does not borrow or otherwise incur leverage, other than limited short-term borrowing (i.e., not a leveraged buyout fund);
- does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances (i.e., long term investments);
- represents itself as a venture capital fund to investors (i.e., not a multi-strategy fund that incorporates venture capital strategies); and
- is not registered under the Investment Company Act and has not elected to be treated as a business development company.

There is also a grandfathering provision for certain venture capital funds but this provision effectively has limited and temporary utility.

Exemption for Family Offices

A "family office" company would be exempt from the definition of investment advisor so long as:

- all clients fall under the definition of "family clients," as described below;
- it is wholly owned and controlled by family members; and
- does not hold itself out to the public as an investment advisor.

The proposed rule contemplates a founding couple, and permits a family office to provide investment advice to the

founders and their parents, siblings, and lineal descendents. The definition of "family client" is relatively generous and addresses spouses and "spousal equivalents;" adopted and step-children; family trusts; family charitable foundations and trusts; other family investment vehicles; former family members such as ex-spouses, key employees and former key employees; and involuntary transfers to non-family members. We believe the SEC sought to draft a thoughtful and permissive definition to incorporate the realities of a typical single family office. However, the devil is in the details. For example, the definition effectively excludes the founders' aunts, uncles, and cousins. This can be particularly problematic when the family office was founded by one or more children or grandchildren of the patriarch or matriarch and thus has the founder's extended family as clients. We are also seeing that many family offices would not be able to avail themselves of the proposed exemption due to restrictions on non-family minority ownership, control, funding or investments in the family's trusts, charities or investment vehicles.

The second condition for the exemption requires the family office be wholly owned and controlled, either directly or indirectly, by family members. Here again, we are finding that non-family minority interests or trustee appointments within the ownership structure are causing some family offices to fall short of the ownership and control requirements.

The third, and likely simplest, condition for the exemption would require that the family office does not hold itself out to the public as an investment advisor. This condition is not thoroughly discussed in the proposal; however, the premise is that a family office holding itself out to the public as an investment advisor is likely a commercial business seeking out non-family clients.

Congress required that the SEC exclude a typical single family office from the definition of an investment advisor. Furthermore, the SEC indicated that it does not want to regulate the traditional activities of single family offices in the management of their own wealth. Public comments on the proposed rule provide numerous examples indicating that many family offices cannot avail themselves of the exemption as written. Thus, the SEC's final rule may be more permissive regarding permitted clients and minority non-family ownership.

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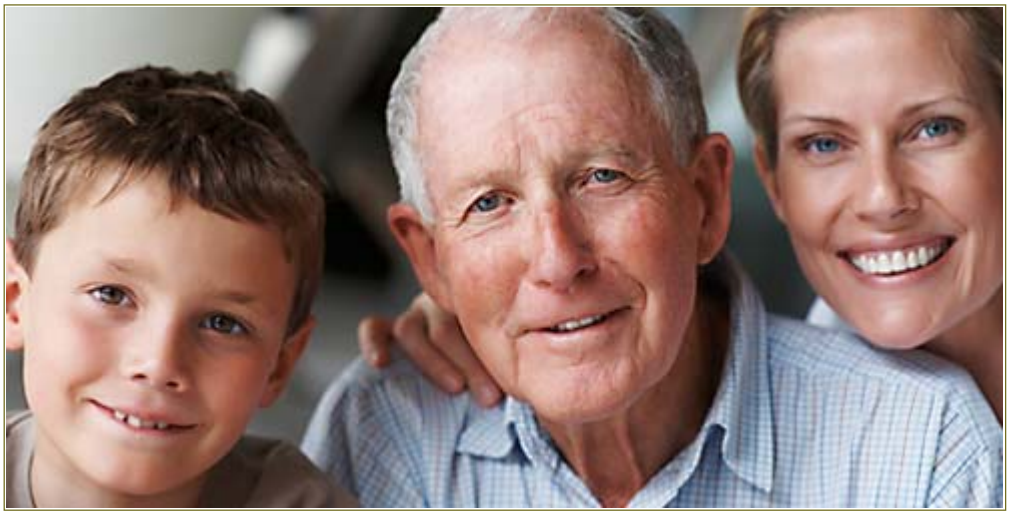
New Gifting Opportunities Under the Tax Relief Act of 2010



Although most publicity surrounding The Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010 (2010 Tax Relief Act), which was signed into law in December 2010, focused on the income tax provisions, it also contains significant taxpayer-friendly changes for estate, gift and generation skipping transfers (GST) taxes.

As a result, the 2010 Tax Relief Act presents a unique window of opportunity for individuals to make meaningful transfers of wealth without being subjected to transfer taxes.

Overview

Under the sunset provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), had Congress not taken action, the gift, estate, and GST tax provisions would have returned to the pre-2002 law on January 1, 2011. This pre-2002 law imposed much more onerous taxes on transfers of wealth. Without the passage of the 2010 Tax Relief Act, the gift, estate, and GST tax exemption in 2011 would have been limited to $1 million; with any transfers above this exemption amount subject to a transfer tax with a top tax rate of 55% (plus a surcharge of 5% on transfers between $10 million and $17,184,000).

The 2010 Tax Relief Act provides for an estate and GST tax exemption of $5 million for 2011 and 2012, with a tax

rate of 35%. The lifetime gift exemption, which was $1 million in 2010, was also increased under the 2010 Tax Relief Act at $5 million for 2011 and 2012. This is a much more generous gift exclusion than most practitioners anticipated. Under the 2010 Tax Relief Act, an individual who already made gifts exceeding the old $1 million exemption, may now give an additional $4 million gift tax free. However, it is important to note that, absent any future legislative action, most of the estate, gift, and GST tax provisions of the 2010 Tax Relief Act expire after 2012, including the $5 million exemption. Under the 2010 Tax Relief Act, in 2013 there will be a reinstatement of the harsh pre-2002 transfer tax provisions discussed above. As such, the time to take advantage of the higher exemption may be limited.

Planning Opportunities

The $5 million lifetime gift exemption in 2011 and 2012 ($10 million, if spouses gift-split), used in conjunction with other estate planning strategies, allows an individual to transfer substantial wealth gift tax free. While there were many proposed changes to limit the benefits of various estate planning techniques looming throughout 2010, they never came to fruition. For example, proposals to eliminate certain valuation discounts for transfers of family controlled entities were not included in the 2010 Tax Relief Act. As such, individuals may continue to take advantage of discounts for lack of control and/or lack of marketability in valuing transfers of family limited partnerships, limited liability companies and other closely-held entities. Since future legislation may again target certain valuation discounts, the window of opportunity to take advantage of these valuation discounts may soon be closing.

Various legislative proposals mandating minimum ten-year terms for grantor retained annuity trusts (GRATs), which would have reduced the planning opportunities associated with this wealth transfer technique, did not make it into the 2010 Tax Relief Act. Zeroed-out GRATs have the advantage of allowing transfers of future appreciation without incurring gift taxes and are frequently set up with short terms (e.g., two or three years). GRATs are particularly effective when interest rates are low, such as now, and individuals should consider establishing short-term GRATs while they are still tax advantageous.

The benefit of techniques like GRATs is derived from the growth in the value of assets contributed in excess of an interest rate that is determined by Internal Revenue Service based on the prevailing rates on treasury securities. Those rates have been at all time lows but are beginning to increase. The end result is that there has never been a better time to use a wide variety of wealth transfer techniques.

For the estates of decedents who passed away in 2010, the 2010 Tax Relief Act reinstated the estate tax retroactively to January 1, 2010, with a rate of 35%. However, for 2010, executors have the choice to opt-out of the provisions of the 2010 Tax Relief Act and instead file a return under the EGTRRA tax regime. This regime provided for no estate tax in 2010 along with modified carryover basis rules for assets that are transferred to beneficiaries. The determination as to whether to opt-out of the estate tax in 2010 is rather complicated and is dependent on the estate's particular facts.

The 2010 Tax Relief Act also introduces the concept of "portability" to the $5 million exemption, whereby the surviving spouse's estate has the ability to utilize any unused exemption remaining at the death of the first spouse. Portability is great in theory as it eliminates the potential for the wasting of the unused exemption of the first spouse to die. Unfortunately, the portability provisions also sunset after 2012 and thus add uncertainty to the estate planning process.

Summary

As a result of the 2010 Tax Relief Act and the lack of clarity with regard to future transfer tax changes, existing wills and trust documents should be reviewed to ensure that bequests still conform to the individual's objectives. In addition to federal transfer taxes, many states impose separate transfer and inheritance taxes that can be substantial and should be considered as part of any estate plan. Therefore, the 2010 Tax Relief Act creates favorable tax planning opportunities, which may be available for a very limited time.

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Economic Growth Through Targeted Tax Credits

The federal government has a long history of using tax credits to spur growth and economic development. The 1981 Economic Recovery Tax Act (1981 ERTA) initiated the tax credit for increasing research and development/experimentation activities (R&D credit).

Since 1981, this credit has been modified and extended numerous times, stimulating experimentation and advancements in a variety of industries. In the "green energy" sector, the investment tax credit, renewable energy grant, and a host of fuel credits and other incentives have been effective in encouraging investment in this critical market.

The majority of the above incentives were due to sunset on December 31, 2010, or earlier. However, with an aim to further spur economic investments, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act) enacted on December 17, 2010, extended many provisions including the R&D credit and several key energy-related tax programs.

Extension of R&D Credit

The aforementioned extension of the R&D credit is retroactive and includes amounts paid or incurred for qualifying research activities after December 31, 2009, through December 31, 2011.

The R&D credit is designed to encourage businesses to increase research and experimental activities and is based on the company's qualified wages, supplies and certain research contracted with third parties. To qualify, a taxpayer's

research and experimental activities must pass a four-part test related to the purpose, nature and application of the research activities.

The analysis to identify qualifying expenditures can be extremely technical in nature and vary substantially from case to case. A key to sustaining the R&D credit upon examination is often contemporaneous documentation that supports both the technical merits of the activities and the related costs.

The extension of the credit does not alter the mechanics of the calculation. Once a taxpayer determines that research expenditures qualify, the credit is generally equal to 20% of the amount by which the taxpayer's qualified expenses exceed a defined base amount. Under this approach, the amount of the credit must be included in taxable income. Often for state planning purposes, companies may elect under Sec. 280C to receive a reduced credit of 13% whereby an increase to taxable income for the amount of the credit is not required.

Alternative Simplified Method

For taxpayers that are significantly limited by the base amount calculation, a second method, called the alternative simplified method may be elected to help maximize the credit. The alternative simplified credit is equal to 14% of the portion of qualified research expenses that exceeds 50% of the average research expenses for the three preceding tax years.

The simplified method can be a practical, tax-saving opportunity for many taxpayers, but careful consideration must be taken. For example, several special rules surround this election, including rules related to consistency, short taxable years, and controlled groups.

Regardless of the method chosen, the R&D credit is claimed on Form 6765 with a timely filed tax return. Also of note, the draft instructions of Schedule M-3 for year 2010 require the separate presentation of R&D costs as a new line item. It is anticipated that compliance with the new requirement may call for significant efforts to gather and report the appropriate information. In addition to the federal R&D Credit, many states have an R&D credit that is modeled, at least in part, after the federal approach.

Renewable Energy Credits

In recent years, renewable energy incentives have fueled the growth of the "green energy" industry. Without these incentives, investment in this area might not be economically viable. The 2010 Tax Relief Act extended numerous alternative energy related tax provisions.

Of particular interest is the extension of the cash in lieu of tax credits program (grant program) available to taxpayers who place specified energy property (e.g., a solar energy project) in service, or, where construction begins, by December 31, 2011. The grant program is in lieu of an energy investment tax credit which provides taxpayers a tax credit of 30% of the cost of installing specified energy property, thus giving taxpayers the option to receive a cash rebate of 30% of the cost of acquiring or constructing a qualifying energy property.

The program is incredibly popular, paying over $5.8 billion of cash grants through the end of 2010—significantly more than originally predicted. At a time when few companies may have been able to utilize a tax credit, the grant program helped spur over 100% growth in the solar industry in 2010. It ultimately advanced 1,100 solar projects and $18 billion in investments. The Solar Energy Industries Association expects the 2011 grant program to help create tens of thousands of new jobs in the coming years.

The 2010 Tax Relief Act also extended the nonrefundable personal income tax credit for certain energy efficient property installed in a principal residence in the United States. This credit, available at 30% in 2010, was extended at only 10% of amounts paid in 2011 for qualified improvements, plus a credit for residential energy property expenditures (e.g., $150 for qualified hot water boilers, $300 for qualified energy efficient property such as heat pumps or air conditioners). This credit is subject to a $500 lifetime limitation.

Other energy credits focus on alternative sources of fuel to replace reliance on oil. Alcohol, biodiesel and renewable fuels credits were extended to incentivize:

i. the use of ethanol mixtures (produced from corn) by gasoline blenders;
ii. the production and use of biodiesel (produced from crops such as soybeans) to replace or supplement petroleum diesel;
iii. the production and use of alcohol blends and certain liquid fuels (produced from feedstock) as fuel; and,
iv. the installation of vehicle refueling facilities that supply alternative fuels or energy.

State Incentives and Exemptions

Just as federal energy incentives were a significant part of the 2010 Tax Relief Act, taxpayers may also benefit from significant state incentives and exemptions. Currently, 24 states offer personal income tax credits for renewable energy property, 25 offer corporate tax credits, 28 provide incentives through sales tax deductions, and most provide some form of rebate or loan program for renewable energy.

Summary

While only time will tell if the recent legislation will provide the economic growth intended, its passage illustrates the importance the federal government placed on innovation as a tool for growth and a continuing dedication to the "green energy" sector.

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Illinois Income Tax Modifications

On January 12, 2011, in the final hours of the final day of the State of Illinois 96th General Assembly's veto session, both chambers narrowly passed income tax rate increases to individuals, trusts, estates, and corporations.

Net operating losses (NOLs) are also suspended and state spending limitations are imposed with tax reductions to the current pre-increase rates should state spending exceed certain limitations. The bill was signed by Governor Pat Quinn on January 13, 2011, and will be effective for taxable years beginning on or after January 1, 2011. The tax increases are designed to be "temporary" with roll-backs scheduled in 2015 and 2025. However, even after the future rate reductions, the individual tax rate will remain higher than the 2010 rate. The enacted changes are outlined below.

Individual Income Tax Rate

The Illinois income tax rate is increased from its current 3% rate for individuals, trusts, and estates to the following:

- 5% for taxable years beginning on or after January 1, 2011, and prior to January 1, 2015;
- 3.75% for taxable years beginning on or after January 1, 2015, and prior to January 1, 2025; and
- 3.25% for taxable years beginning on or after January 1, 2025.

Corporate Income Tax Rate

The corporate income tax rate is increased from its current 7.3% rate, which includes the personal property replacement tax rate, to the following:

- 9.5% for taxable years beginning on or after January 1, 2011, and prior to January 1, 2015;
- 7.75% for taxable years beginning on or after January 1, 2015, and prior to January 1, 2025; and
- 7.3% for taxable years beginning on or after January 1, 2025.

Net Operating Losses

NOLs are suspended (except for S corporations) for tax years ending after December 31, 2010, and prior to December 31, 2014. NOLs generated during this period and all prior NOLs that could be carried forward into the suspension years are preserved and carried forward for the four-year-period.

Estate and Generation-Skipping Transfer Tax

The Illinois Estate and Generation-Skipping Transfer Tax Act, which lapsed in 2010, has been reinstated for persons dying after December 31, 2010. The reinstated tax is equal to the full amount of the state tax credit on the federal estate tax return that would have been allowed under the Internal Revenue Code in effect on December 31, 2001. The rate is graduated up to a maximum of 16% of the adjusted taxable estate for estates over $10 million. In contrast to the current federal exemption of $5 million, the Illinois exemption equivalent is limited to $2 million. As a result, there may be a need to address estate plans for Illinois residents, particularly those with taxable estates between $2 and $5 million.

Local Government Impact

The Local Government Distributive Fund (LGDF) is excluded from the funds collected from the additional tax imposed under this act. Currently 10% of the collections under the individual income tax are allocated to LGDF for distribution to counties and municipalities based on their proportionate share of the state's population.