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Tax Traps and Opportunities: Planning for Same-Sex Marriage

On February 14, 2012, Washington State joined New York, Connecticut, Iowa, Massachusetts, New Hampshire, Vermont and the District of Columbia in recognizing same-sex marriage.

As of this writing, Maryland and Illinois are also considering similar legislation. In extending these legal rights to same-sex couples, some unique and challenging tax planning issues were also created.

Although marriage and its legal implications are governed by state law, for federal purposes the Defense of Marriage Act (DOMA) defines marriage as a relationship between one woman and one man. Therefore, most federal law, including federal tax law, does not recognize same-sex marriage. This inconsistency has a significant impact on planning for same-sex couples and can lead to some surprising and unwanted results.

Much of family wealth planning involves, to some extent, the unlimited marital deduction. This deduction allows an individual to transfer via gift of bequest unlimited assets to his or her spouse completely transfer tax free. Under DOMA, however, same-sex couples are not afforded this deduction. Aside from the obvious issues of not being able to give assets to your spouse free of gift or estate tax, there are some less obvious tax traps where state property law and federal tax law intersect.

Most married couples own at least some property as joint tenants with a right of survivorship (referred to as Joint

Tenants With Rights of Survivorship or JTWROS). This type of ownership creates gift tax implications that are usually ignored for married couples because of the marital deduction. For same-sex couples, however, these implications must be carefully considered.

In the most obvious example, if the owner of property were to add a same-sex partner as a JTWROS, a gift of one-half the property's value results. There is an exception to this rule for joint tenants of assets such as bank accounts where the contributing joint owner can revoke the account at any time. In such cases, no gift occurs until the non-contributing owner actually withdraws the funds. However, because of the property rights marriage creates in certain states, this exception may not apply.

In states such as New York, married joint owners with survivorship rights own property as tenants by the entirety. This type of ownership is the same as JTWROS with the exception that such account cannot be severed unilaterally. As a result, the mere creation of the account causes an immediate gift, the value of which is calculated actuarially. Likewise, in community property states such as Washington, the conversion of community property into separate property and vice versa also creates a taxable gift. Because of these unintended and often counterintuitive results, it is important that same-sex couples be aware of the rights created by various forms of property ownership.

Along with these gift tax issues, joint ownership also creates estate tax complications for same-sex couples. Under the tax code, if a spouse dies owning property as a JTWROS, one-half of the property is deemed included in that spouse's estate. That half then gets a step-up in basis and passes to the surviving spouse estate tax free. For unmarried joint owners, which includes same-sex married couples, not only is there no marital deduction, but it is presumed that the deceased joint tenant owned 100% of the property (or the funds used to purchase the property) and thus, 100% of the value is included in the estate unless evidence can be produced proving otherwise. To avoid this result, same-sex couples must maintain detailed records for all property owned jointly.

Another area that can be problematic for same-sex couples is the generation-skipping transfer (GST) tax regime. In the case of unrelated people, any recipient of assets who is more than 37 ½ years younger than the person transferring those assets is considered to be more than one generation below that person and thus, the GST tax applies. For heterosexual couples, the age difference between spouses is meaningless because married couples are considered to be the same generation. If same-sex spouses are more than 37 ½ years apart however, an asset transfer can create not only gift or estate tax, but GST tax as well.

There is one notable area in which DOMA does provide an advantage to same-sex couples. Prior to 1990, a common family wealth planning technique was to transfer an asset to the next generation but retain an income interest over that property for a term of years. As a result, the transfer value of the property was less than its full value. Savvy planners would intentionally select an asset that produced little actual income, making the true economic value of the retained interest a nominal amount. This transaction is known as the grantor retained interest trust, or GRIT. In response, the government introduced Sec. 2702 which states that this retained interest, unless meeting specific requirements, is ignored for valuation purposes so that the transfer value would be the asset's full value. However, this section is only applicable to certain related parties, a statutorily-defined group which does not include same-sex couples. Therefore, the GRIT can be used to transfer assets between same-sex couples at a substantially reduced gift tax value. In addition, GRITs can also be used to transfer assets to a same-sex spouse's child.

As more states recognize same-sex marriage, the need for this specialized planning will continue to grow. Because of DOMA and the various and often differing state laws, traditional family wealth planning must be reexamined in this context and planners must consider all the potential pitfalls and opportunities in order to properly serve same-sex couples and their families.

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Managing Currency Risk for the U.S. Investor

As we progress into 2012, the spotlight continues to shine brightly on the foreign exchange market with the focus centered on Europe's ongoing sovereign debt crisis and its impact on the euro.

This is an opportune time to review the fundamentals of the foreign exchange market (a.k.a. the currency market) and create an appropriate investment strategy for managing one's currency risk within their portfolio.

Overview of the Currency Markets

If asked to name the world's largest and most liquid market, many may be surprised to hear the answer is the currency market. This is especially impressive considering there is no centralized exchange for trading currencies. Fundamentally, however, it is rational that such a globalized world requires an accessible transfer of currency to be able to transact beyond borders.

The average daily currency turnover is currently $4 trillion, compared with $3.3 trillion in 2007, indicating an ever increasing market and global economy. However, the market is still heavily weighted within particular geographical areas, as 37% of all currency market trading takes place in the UK and 18% in the United States. The U.S. dollar is the most highly traded currency at 43% of the market compared to 20% for the euro. As the world continues to become more interconnected and emerging economies grow, the currency markets may experience considerable

changes.

Currency markets are extremely sensitive to world events and are viewed as the most reliable market to accurately reflect global economic and political changes. Currencies are generally fairly valued over the long term, but like equity or fixed income investments, there are times when a combination of economic, political, and psychological factors causes some currencies to be over- or under-valued relative to others. Being such a liquid market, impacts of significant events can be seen within currency trading almost immediately.

Currency Effects on a Portfolio

Investments in international securities can generate positive returns and add a greater degree of portfolio diversification, but the underlying exchange rates introduce an added risk. Since foreign exchange rates can have a significant impact on portfolio returns, investors should be mindful of their portfolio's exposure. Studies show that over time the expected return from unmanaged currency exposures is zero, even despite an increase in risk.

International investments can either be hedged or unhedged to the foreign currency. If unhedged, the investor has full currency exposure and their portfolio value will fluctuate based on the changes of the foreign currency relative to their domestic currency. These unhedged currency effects can therefore, help or hurt the returns of the underlying investments, and tend to provide incremental volatility without additional long-term return.

On the other hand, investments can be hedged against currency risk, either with a passive or an active approach. Passive hedging is achieved by maintaining a fixed currency hedge percentage in the investment. For example, if a U.S. investor is hedged 100%, their investment will always be denominated in U.S. dollars and will not realize the positive or negative effects of an appreciation or depreciation of the foreign currency. Although less volatile than an unhedged investment, passive hedging tends to be more volatile than active hedging. Active hedging is achieved by allowing the investment portfolio's currency exposure to fluctuate based on the market environment, usually within a specified range. This gives the investment manager the discretion to change the level of the hedge when they see opportunities or risks.

Investment managers typically base their investment decisions primarily on the strengths of individual companies that meet the objectives of their defined strategy, but they will often adjust the related currency exposures based on the fundamentals and outlook of the foreign exchange market. The recent S&P downgrades of nine euro-zone countries and the turmoil associated with the euro is a prime example of why hedging international investments is a timely and significant issue. Of course, hedging necessarily also limits potential upside to currency exposure, and there are added transaction costs to execute the hedge that may also hold down returns. From 2002-2010, for example, when most foreign currencies appreciated relative to the U.S. dollar, an unhedged foreign security portfolio would have outperformed an equivalent hedged portfolio. The value of the hedge is in reducing return volatility during these changing periods with the right strategy in place to mitigate the risks while seeking to take advantage of opportunities when they arise.

Conclusion

The currency market is the engine of the global economy. It is massive, complex, self-regulating, and a major driver in country development and world trade. Because currency markets change rapidly based on the world's economic environment, it is very important to have the proper currency management strategy in place. Hedging foreign currency exposure for U.S.-based investors typically reduces volatility, and can be executed with a passive or active strategy. Hedging is ultimately a strategic decision based on an optimization of investment risk and return. Since currency markets are so cyclical in nature, currency movements give investors an opportunity to consider the

timing of initiating a hedging program on a tactical basis. You should confer with your investment consultant or your portfolio managers to determine which type of strategy they utilize and make certain that strategy is most appropriate for you.

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Business Valuation and Exit Strategies in Volatile Markets

Recent uncertainty regarding U.S. creditworthiness, growing concerns about the European debt crisis, a slowdown in the Chinese economy, and central bank interventions in the United States and Europe have all contributed to a more volatile financial market environment as evidenced by the Chicago Board Options Exchange Market Volatility Index (VIX), a measure of the implied one-month volatility of S&P 500 index options.

Since 1990, the VIX has averaged approximately 20% but has skyrocketed in recent years, rising to nearly 90% in October 2008 and fluctuating as high as 48% in August 2011. How can an owner of a privately-held business determine the value of his or her interest in these volatile times? And what exit strategies are available?

Valuation

Several different valuation techniques can be applied to determine the fair market value of a privately-held entity or asset. The three major methods used by valuation specialists are the Market, Income and Cost Approaches. Valuation specialists do not usually rely on a single approach but, rather, meld the results from several approaches into a cohesive conclusion of value.

The Market Approach measures the value of a business through an analysis of recent sales or offerings of

comparable investments. The valuation specialist can use value indications based on sales of private companies as well as current market multiples from comparable publicly-traded entities. When considering the Market Approach, the valuation analyst must identify the best possible set of comparable guideline companies. Once this peer group is developed, the analyst must go through a formal process of comparing the subject company to each of the comparable companies and make adjustments to reflect relative growth expectations, risk profiles and profit expectations. This can be a lengthy process involving a detailed quantitative and qualitative analysis of each guideline company.

The Income Approach aims to quantify the present value of all of the entity's expected future cash flows. A discount rate must be applied to future cash flows in order to reflect the time value of money as well as the risk related to achieving the cash flows. Preparing an income approach in volatile times can be a challenging exercise. It is important that the forecasted cash flows be tested based on current market evidence. It is also important that the discount rate reflect the real risks associated with realizing the economic benefits based on all current market and industry data.

Finally, the Cost Approach is centered on the idea that the total value of an entity can be estimated by the sum of the fair market value of its parts. Each of the company's assets and liabilities are adjusted to its fair market value. Once the fair market value has been ascertained for all of the entity's assets and liabilities, the liabilities is subtracted from assets, yielding the entity's net asset value. This approach is typically used to determine the value of real estate holding companies and asset intensive companies and is usually not appropriate to apply to determine the value of a company that provides services or products or holds significant intangible value. However, if this approach is employed, the valuation specialist must take steps to ensure the valuation of the assets and liabilities reflects current market conditions. This can be difficult in volatile times.

Exit Strategies

When planning an exit strategy for a privately-held business, the following primary liquidating events are typically considered:

- Initial public offering (IPO)
- Private sale of the business
- Mezzanine financing

IPOs, if successful, can offer stakeholders exceptional returns on their investments. IPOs allow early equity-holders to dramatically increase the liquidity of their holdings, expose the company to access to cheaper capital, diversify the company's equity base and enhance the public image of the company. However, successful IPOs require relatively high value thresholds and the rewards of going public through an IPO are generally accompanied by high costs including accounting and SEC filing requirements, investment banking fees, legal costs, and increased transparency and public dissemination of company-specific information.

A more conventional exit strategy is to sell the business to a private investor group, often a private equity or venture capital firm. In such transactions, the firm acquires all or nearly all of a company, then seeks to extract additional value by reorganizing and optimizing the operations of the company through changes in capital structure, management and strategy. Whether an asset holder wishes to exit a business entirely or merely liquidate a portion of an interest in a private company, a sale to a private investor can achieve an exit strategy without many of the costs and challenges of a public offering.

Finally, mezzanine financing allows an owner to transfer ownership and increase their personal liquidity in a

non-disruptive and cost-effective fashion. Using a combination of debt, preferred equity, and derivative securities such as convertible debt or warrants, a mezzanine financing firm provides companies access to additional funds. These funds can be used to help grow the company further, or allow middle management to buyout the stock of the company's founder to facilitate a transition of management and grant an owner an opportunity to exit the company at fair market value.

It is critical that an owner of a privately-held business have a good understanding of the value of his or her business for a variety of reasons including estate, gift and strategic planning, as well as for the consideration of potential liquidity events. It is always a good idea to seek advice from a qualified professional, particularly in these volatile times.

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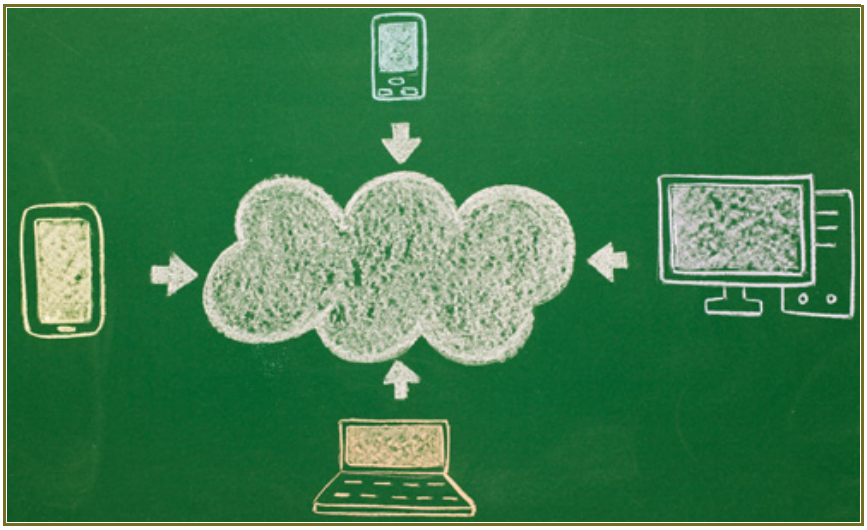
Software In The Clouds…The Tax Answer May Be a Bit Foggy!



Over the last few years, state taxing authorities have eyed the growing digital products market as a potential lucrative source of revenue and/or as an increasing erosion of their tax base.

The latest controversy regarding the taxability of software is "cloud computing." Cloud computing is an arrangement to access and use hardware and software hosted on the server of a vendor for a fee.

Many state statutes do not specifically address cloud computing and states are taking differing positions regarding the sales and use tax treatment of a cloud model. Without any uniformity, there is greater risk of multiple jurisdictions applying tax to the same transaction given the borderless nature of cloud computing, which presents both compliance and enforcement challenges.

What is cloud computing?

In layman's terms cloud computing typically encompasses the delivery of common business applications that the user can access online through a web browser. More formally, the U.S. National Institute of Standards and Technology's (NIST) definition of cloud computing includes five essential characteristics: on-demand self-service; broad network access; resource pooling (e.g., multi-tenancy); rapid elasticity and usage-based billing (i.e., pay as you go).

In practice, the cloud has been defined as having three primary service models:

- Infrastructure as a Service (IaaS), which is raw computing power, storage and network bandwidth;
- Platform as a Service (PaaS), which is database, development tools and other components required to support the delivery of custom applications; and
- Software as a Service (SaaS), which includes applications both general, such as word processing, email, spreadsheet, and specialized, such as customer relationship management (CRM), enterprise resource management (ERM), etc.

Over time, the market has evolved such that you can buy a subset of any of the services offered within these three models. Other ancillary cloud services include content delivery, ecommerce, networking, messaging, and payment and billing. Ancillary services may be taxable even if offered with cloud service (e.g., physical storage, discs, tapes, etc.). As such, the bundling of taxable with nontaxable services can taint the entire transaction and could increase the amount of tax paid or collected on a given transaction.

Generally, there are three parties to the cloud computing transaction – the customer, the software vendor and the hosting company. In some cases, the hosting company and the software vendor may be the same company. In a typical arrangement, the customer contracts with the vendor to use software. Then the vendor contracts with the hosting company to house and maintain the software. Ultimately, the customer interacts directly with the hosting company to access software/applications.

Cloud Computing Sales & Use Tax Issues

From a software/service provider perspective, the biggest concern is to determine in which states they have nexus, and thus, a potential filing obligation. The software/service provider must consider its physical presence (e.g., servers, software, sales and service people, business development activities, etc.) and any nexus it may have from affiliate relationships. The software vendor must also consider whether the license or use of the software gives the software vendor nexus in the host state.

The two primary issues that impact both the service provider and the consumer are the characterization of the transaction and where the transaction is sourced.

Characterization of The Transaction

States can characterize transactions in a variety of ways in an attempt to tax the transaction as tangible personal property, a taxable service or possibly a bundled transaction. A taxing jurisdiction will usually make the following inquiries when determining the characterization of the transaction:

- Does the customer receive a copy of the software?
- Does the seller use the software to provide a nontaxable service?
- Does the seller license software to the purchaser for the purchaser's own use?
- How do the parties characterize the transaction in the sales contract and invoices?
- Is the seller required to provide additional services as well as giving access to the software?
- If the seller provides both services and software, do the contract and/or invoices separately state the charges?

States will not always agree on characterization of what was purchased. For example, basic computing can be classified in one of four ways: 1) as a non-taxable service; 2) as a taxable information service; 3) as a taxable communication service; or 4) software as a service (SaaS). Messaging can be treated as a nontaxable service or as

taxable communication services. The following provides examples of how states can characterize cloud computing services for sales and use tax purposes.

Taxable Services

- **Ohio**: Providers of internet access and online services are providing an electronic information service subject to Ohio sales and use tax to the extent that the service is provided to a consumer for the consumer's use in business.
- **Texas**: The state recently ruled that fees for accessing a hosted software application were deemed to be taxable data processing services, regardless of whether the data entry was performed by the customer. Texas, like other states, does allow for the apportionment of services provided to out-of-state customers.
- **New York**: The state taxes information services. In a recent ruling to a taxpayer providing web-based subscription services for a fee, New York determined that if a common database is used to generate reports or otherwise disseminate information, the information sold is subject to sales.
- **South Carolina**: A number of state rulings determined database access charges would be included in taxable communications and charges by the application service provider (ASP) are similar to charges by database access services and therefore subject to tax.
- **Washington Business and Occupations Tax (B&O)**: Gross income received for providing remote access to applications on the host's servers are subject to the B&O tax when the service is performed in Washington.

Transfer or Lease of Tangible Personal Property

In jurisdictions where cloud computing transactions cannot be classified as a taxable enumerated service, rulings have been issued indicating that the transaction is really a transfer or lease of tangible personal property. For example:

- **New York**: A state ruling determined that the location of the code embodying the software is irrelevant, because the software can be used just as effectively by the customer even though the customer never receives the code on a tangible medium or by download. The accessing of software by customers constitutes a transfer of possession of the software, because the customer gains constructive possession of and gains the right to use, control or direct the use of the software.
- **Utah**: The state has ruled that hosting software and customer databases are taxable as a “lease” or “rental” of server space, even though no specific server space is assigned to the user.
- **City of Chicago**: The city has ruled that where possession of the computer is not transferred, use of a computer is deemed to occur at the location of the device used to access the computer.

Sourcing the Transaction

With regard to the sourcing of a transaction, it is difficult for the vendor or hosting company to determine the location of the customer and/or where use occurs. Some states may source the transaction where the taxable product or service is used. Other states may source it based on the location of the servers. Some states may even source it where the office of the cloud computing provider resides. Generally, it will be based on destination where the customer accesses or uses the software/service. A tax jurisdiction will raise the following questions when determining sourcing:

- Where is the cloud computing located?
- Is the vendor or the hosting company physically present in the state?

- What state has the right to tax it?
- Is actual possession of the software/hardware required?
- Is multiple jurisdiction use a factor?
- Where are the datacenters located?
- Where is the software housed?
- Can the hosting company's in-state activities be attributed to the software vendor?

In determining whether the transaction is taxable, it is helpful to look to a state's treatment of ASP, SaaS, hosted, cloud computing and electronically delivered software. Further, analysis is required to determine what is actually received by the customer. Is it access to computer software? Is it access to infrastructure? Are they bundled transactions? Prewritten software or even hardware may also be part of the cloud computing arrangement. In a bundled transaction, some states will tax the entire transaction unless evidence supports the taxable component is de minimis. Others states require components be separately stated to be exempt. Regarding planning, taxpayers need to develop a corporate policy that supports the following whenever practical:

- receive software in an electronic form;
- specify the delivery method and sourcing in the contract and purchase order;
- consider incorporating a certificate of electronic delivery into the contract which is signed by both parties;
- require documentation of proof of e-delivery (e.g., a copy of license keys or email from software vendor with access codes);
- involve tax personnel in major purchases to scrub contracts for troublesome language;
- consider services related to the purchase and how they may be taxed; and
- educate purchasing to decline acceptance of TPP (e.g., back-up disc).

Given the wide range of benefits associated with cloud computing services, specifically, the reduced corporate expenditures on costly purchases and maintenance of computer hardware and software, servers and data centers, we will continue to see those services expand. State taxing authorities will undoubtedly continue to develop policy through the issuance of administrative rulings and guidance, promulgate rules and propose legislation to capture this important growing revenue source.

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Large Trader Rule May Snare Some Individual Investors

"SEC to UHNW: Get CIK on EDGAR, get LTID thru 13H, tell BD."

This is not a text message your teenager sent discussing weekend plans. Unfortunately, it is a brief description of SEC's new Large Trader Identification System that has thrust new regulatory requirements upon certain unsuspecting wealthy investors and family offices.

After the flash crash in May 2010, the SEC implemented a rule requiring "Large Traders" to self-identify themselves by filing new Form 13-H through the SEC's EDGAR system. A Large Trader is defined, in part, as any person who, for his own account or for an account for which he exercises investment discretion, effects transactions in exchange-listed securities in an aggregate amount equal to or in excess of either:

- 2 million shares or $20 million in value on any day
- 20 million shares or $200 million in value in any calendar month

Thus, a wealthy individual who day trades or a family office making investment decisions for several family accounts may need to self-identify if the daily threshold is crossed just once. Many individuals and family offices entrust discretionary investment authority to outside advisors, relieving them from the requirements. However, those who manage their own investments are considered to exercise discretion over their own accounts.

The SEC estimated that only 400 people or entities will be considered Large Traders, but we believe the net is in fact much broader. It is not implausible to imagine a family office selling a position across several family members' accounts totaling $10 million, and reinvesting the $10 million into other securities, thereby crossing the $20 million threshold. Furthermore, even if several affiliated traders themselves do not cross the threshold, the controlling parent entity must aggregate their trades and may itself be a Large Trader required to self-identify. In this respect, the SEC has set the bar much lower than IRS requirements to be considered a "trader" for purposes of the passive-activity loss rules, which emphasize active and ongoing involvement in trading activity rather than the absolute magnitude of trading activity.

Certain transactions are exempt from the calculation of trading activity, including gifts or estate distributions, employee stock or option awards or sales, mutual fund trades, IRA rollovers and private placements.

Information submitted on Form 13-H, such as types of business, people involved, form of organization, brokers used, affiliates and trading strategy will not be publicly disclosed. Large Traders are required, however to provide their large trader identification number to their brokers, and brokers may contact you to request your number. Even though the initial deadline for reporting has passed (December 1, 2011), the SEC has stated that it may request information from brokers about their customers who appear to be potential large traders.

Because the SEC so broadly defined a Large Trader we suspect this may be a trap for the unwary. As with any significant transaction, an acute understanding should be gained with respect to both tax and regulatory reporting requirements.