SNSFE QUARTERLY REVIEW

Second Quarter 2007- ISSUE 4 — **A newsletter for our clients and friends**

From the President

Steven C. Filipowski

Governor Rod Blagojevich recently proposed the introduction of a new tax on Illinois businesses, the Gross Receipts Tax ("GRT"), in order to raise money for various proposed social programs and to cover the State's pension funding shortfall. The GRT is an amendment to Illinois Senate Bill 429 which seeks to overhaul the present corporate taxation system in Illinois. Opponents of the GRT, including the Illinois Chamber of Commerce, argue forcefully that the tax will have disastrous effects on Illinois jobs and business.

The GRT applies to businesses with greater than $1,000,000 in gross receipts in a given tax year. It provides for two separate tax rates, .85% to be applied to the sale of goods, and 1.85% that applies to the sale of services. A business that sells both goods and services will be subject to both rates on a per transaction basis. The lower rate would apply to "…gross receipts from sales, leases, or rentals of tangible personal property, or from construction contracts pursuant to which tangible personal property is incorporated into a structure or improvement on and becomes a part of real property…" The bill states that the lower rate applies to transactions that both occur and do not occur in Illinois so long as they would be subject to the Retailers' Occupation Tax Act, or would be subject to the Retailers' Occupation Tax Act but for the fact that the transaction is exempt because it is a resale, an occasional sale, or otherwise falls under a specific product or use-based exemption.

SB 429 defines gross receipts broadly as "the total amount realized by a taxpayer without deduction for costs of goods sold or other expenses incurred." The bill also provides a non-exhaustive list of examples of gross receipts. SB 429 also allows certain deductions from gross receipts including: cash discounts allowed and taken, returns and allowances, and bad debts. The definition of gross receipts specifically excludes: receipts from the retail sale of food to be consumed off premises; receipts from sale of medicine and medical devices to the extent that such sales are also subject to the 1% Retailers' Occupation Tax; dividends and gross receipts of a disregarded entity received by an individual; receipts by an individual from the sale of a capital asset as defined by IRC § 1221; proceeds attributable to the repayment of the principal amount of a loan; wages and benefits received by an employee; proceeds from the sale of a company's own stock or other securities; life insurance proceeds; certain legal damages not attributable to amounts that otherwise would have been gross receipts; tax refunds; sales or other taxes collected by a taxpayer which the taxpayer is required by law to collect; various other amounts received not traditionally characterized as revenue.

The proposed bill incorporates the defined term "gross receipts" into the defined term "Illinois gross receipts". Illinois gross receipts are all "gross receipts" from transactions connected to Illinois. The connection to Illinois required by SB 429 is a bit different for each type of transaction and is generally found where the goods or services are actually used in Illinois (see Client Alert at snsfe-law.com for more details).

SB 429 would give an allowable credit to taxpayers by reducing the amount of GRT owed to the State by the current amount of its Illinois Income Tax burden. Other than businesses with gross receipts of less than $1,000,000, the GRT would not apply to charitable entities qualified under IRC § 501(a) nor to any foreign, state, or the federal government or any of their political subdivisions. It would also not be applied to businesses in the gaming industry, or to Medicaid payments to doctors and hospitals. Other exempt organizations and industries are given such status through the types of transactions excluded from the definition of gross receipts, as detailed above (e.g. retail food and drug sales).

It should be noted that SB 429 specifically disallows the direct billing of the GRT to customers (e.g. tax shown on retail sales receipt); however, there is no requirement that businesses keep their prices at pre-GRT levels, thus tempering the effect of this provision. Also, a disregarded entity will pay GRT on the entity level. And, it is entirely possible, and in fact probable, that a business that operates at a loss will be subject to the GRT.

The Illinois Chamber of Commerce is organizing opposition to the tax and may be contacted at 312.983.7100 or info@largesttaxincreaseever.com. For additional details, please refer to Client Alerts on our website.
Thanks to Clint Costa for his assistance in the preparation of this letter.

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IN THE NEWS:

Steve recently appeared in a Leading Lawyers Network spot in a *CRAIN'S A.M.: PEOPLE IN THE NEWS* newsletter. He was chosen for his work in commercial litigation and employment law: management.

If you'd like information on Steve's practice, please don't hesitate to contact him at 312.621.4400 or at SFilipowski@snsfe-law.com.

Protection Of Sensitive Business Information

Non-Disclosure Agreements - What Works, What Doesn't Work and Why

Henry N. Novoselsky

Most businesses create or maintain and use non-technical, business informational data which is held with some degree of confidentiality to prevent unauthorized disclosure. This information can consist of internal financial data, profit and loss information, debt structure and financial projections, profit margins and manufacturing costs, pricing and discount formulas and structure and bidding procedures, and pricing, distribution and marketing plans.

hat is common to all of this non-technical business data is that such information may not be considered by a court to rise to the level of trade secrets. Should that prove to be the case, an employer's proprietary business information will not be protected against disadvantageous disclosure and use by a former employee **UNLESS** that employee had entered into a valid and enforceable covenant precluding post-employment disclosure. If such a covenant is not in place, or if an existing covenant is found to be overbroad or otherwise unenforceable, the former employee will be free to disclose and use his or her former employer's business information for such purposes as he or she sees fit.

Covenants not to compete, as restraints on trade, will be upheld and enforced only when necessary to protect an employer's legitimate business interests.

Misuse of covenants not to compete. Experience has shown that many businesses utilize covenants not to compete as the contractual vehicle with which to seek to prevent disclosure of proprietary business information. This is a serious and generally unnecessarily expensive mistake -- using a nuclear bomb where a flyswatter would be appropriate.

Covenants not to compete have the purpose of preventing competition and are viewed as restraints on trade. They are not favored as contrary to public policy and are subject to substantial judicial scrutiny when sought to be enforced. Further, covenants not to compete, as restraints on trade, will be upheld and enforced only when necessary to protect an employer's legitimate business interests, such as a near-permanent relationship with existing customers, and then only to the extent necessary to protect those interests. Thus, a covenant not to compete must be limited in time and geographic scope and not exceed restraints necessary to protect the employer's legitimate interests. Should the covenant prove to be overbroad, a court need not blue-pencil or rewrite the restrictions down to a reasonable scope and may decline to enforce the covenant as unreasonable.

Covenants not to disclose, on the other hand, are not intended to prevent competition, but to preserve the confidentiality of an employer's proprietary business information. Covenants not to disclose, therefore, are subject to a substantially lower degree of judicial scrutiny. Further, due to the clear difference in the two types of post-employment restraints, covenants not to disclose generally need not contain "reasonable" (or any) geographic or time limitations. As a result of these material differences, covenants not to disclose have proven to be more readily enforceable in the courts and enforceable in proceedings where judicial inquiry is more limited to questions of whether the information in question is truly not in the public domain and has been the subject of reasonable attempts to ensure its confidentiality.

WHAT WORKS, WHAT DOESN'T WORK AND WHY

If you don't keep it confidential, no court will. Courts will enforce non-disclosure agreements only if the employer itself treats its proprietary business information as confidential. As non-technical business information may not rise to the level of trade secrets, protectable without an underlying non-disclosure agreement, a valid and enforceable non-disclosure agreement must be in place. Procuring a non-disclosure agreement, however, is not enough, the employer must also take reasonable steps to ensure the confidentiality of its business information. Such steps are varied, determined by the nature of the business, but can include restricted access to computerized data by password control, keeping track of hard copies of the data and otherwise restricting access to the information to those having a need to know. Only if appropriate steps are taken to actually preserve the confidentiality of the information will a court enforce the contract to restrict disclosure, for a failure to keep the information confidential will be deemed a waiver of its confidentiality.

A non-disclosure agreement procured shortly before an employee is terminated is of little or no value.

Non-disclosure must be limited to proprietary business information. Although a non-disclosure agreement will not be subjected to the same degree of judicial examination as a covenant not to compete, nonetheless the restriction against disclosure cannot extend beyond that necessary for the protection of legitimate business interests of the employer, in this case, the protection of proprietary business information held confidential against unauthorized disadvantageous disclosure. The non-disclosure agreement, therefore, should set forth more than a mere vague and broad statement as to the nature of the information not to be disclosed, such as "business practices", "methods or means" and the like, as a court reviewing the agreement would then be unable to determine whether protectable interests exist. An agreement not to disclose which describes the information subject to the restraint with specificity is one which a court will enforce if otherwise appropriate. A vague description of protected information or an attempt to restrain disclosure of information in the public domain or generally available within the employer's industry will result in an unenforceable covenant.

The covenant must be supported by real consideration. Often overlooked is the fact that an agreement not to disclose is a contract and, like other contracts, must be supported by real consideration. Therefore, if the non-disclosure agreement is not made at the time employment commences, an employee must receive something of value in exchange for his or her new obligation not to disclose (a promotion, stock options, etc.). If the employee is at-will, continued employment will support the agreement only if that continued employment is "substantial" in nature, that is, if it continues for some period of time. A non-disclosure agreement procured shortly before an employee is terminated is of little or no value.

These are general observations as to the manner in which the Circuit Courts generally deal with covenants not to compete and post employment restraints. The space allotted is not sufficient to address this very broad topic in any detail. You should consult counsel regarding any specific application. For more information, Henry Novoselsky can be reached at 312.621.4400 or HNovoselsky@snsfe-law.com.

Spouses Rule! *When it comes to naming a death beneficiary for a qualified retirement plan despite PPA.*

Scott E. Galbreath

surviving spouse has many advantages when "inheriting" a qualified retirement plan account balance from a deceased participant. Generally, a beneficiary must receive a deceased participant's entire account balance either within 5 years of the year of death (5-year rule) or through annual distributions over his/her life expectancy beginning the year after the year of death (life expectancy rule). A retirement plan can choose which rule applies by specifying it in the plan document or it can provide that the participant or beneficiary may elect which rule applies. If the plan is silent, the life expectancy rule applies if the participant named a designated beneficiary. If not, the 5 year rule applies. However, there are special rules when the beneficiary is the surviving spouse.

Provided the spouse is the "sole beneficiary" of the participant's account, if the participant dies before having to take minimum required distributions (generally by April 1 after reaching age 70½) the surviving spouse need not begin taking distributions until the participant would have had to take distributions. In contrast, if the life expectancy rule applies, a nonspouse must begin taking distributions by the end of the year after the year of the participant's death. Thus, if an age 60 participant died in 2007 leaving an age 55 nonspouse sole beneficiary of his $500,000 401(k) account, the 2008 required minimum distribution under the life expectancy rule would be $17,422 which must be distributed before the end of 2008. However, if the participant left the account to an age 55 surviving spouse as the sole beneficiary she need not begin distributions until the participant would have reached age 70½. Therefore, a surviving spouse can enjoy additional income tax deferral that the nonspouse cannot. In addition, when required minimum distributions are paid to the surviving spouse her life expectancy is recalculated annually resulting in smaller distributions. A nonspouse's life expectancy is calculated only once.

At age 71 the first required distribution from a $500,000 account to a nonspouse is $30,675 whereas the distribution to a spouse is only $18,868.

Perhaps the biggest advantage for a surviving spouse is the ability to roll over the decedent's retirement account into an account of his/her own tax-free. In the above example, the 55 year old surviving spouse could roll over the account into an IRA. She would not have to start taking distributions from the IRA until she reached age 70½ (instead of when her husband would have turned age 70½) giving her a full 5 years more of income tax deferral on the earnings. Additionally, as her own IRA, her required distributions would be calculated using the Uniform Lifetime Table providing for a longer life expectancy and resulting smaller annual distributions, rather than the Single Life Table used for nonspouses or spouses that are not the sole beneficiary. This amount is significant. For example, at age 71 the first required distribution from a $500,000 account to a nonspouse is $30,675 whereas the distribution to a spouse is only $18,868. Each year the spouse keeps more money ($11,807 for the first year alone) in the account earning tax deferred income.

Prior to 2007, nonspouses could not roll over survivor benefits from a qualified retirement plan to an IRA. The Pension Protection Act of 2006 (PPA) provided that beginning in 2007 if a nonspouse beneficiary directly rolls over the death benefits into an IRA designated to receive such benefits, the rollover will be tax-free to the beneficiary. The rollover must be directly from the qualified plan to the IRA in a plan to plan transfer. According to legislative history, the purpose of the provision was to allow nonspouses to avoid immediate taxation of such benefits.

However, the nonspousal rollover is not as advantageous as it first seemed and recent guidance from the IRS further restricts its utility. First, a nonspouse beneficiary will not be able to roll over benefits to an IRA if the plan does not permit such a direct rollover. While a qualified plan is required to transfer certain eligible rollover distributions directly to another plan or IRA when elected by the recipient (such as on separation from service) in order to be a tax qualified plan, the IRS maintains that offering the nonspousal direct rollover distribution is not a requirement, but a permitted option. One must wonder if Congress intended that qualified plans could choose not to offer such direct rollovers.

Second, the nonspouse beneficiary cannot elect to treat the rollover IRA as his/her own as a spouse can. The PPA provides that the rollover IRA is treated as an inherited IRA which means the nonspouse beneficiary must receive benefits under the 5-year rule or life expectancy rule. According to the IRS, instead of the beneficiary or IRA electing which rule applies, the rollover IRA must make distributions to the nonspouse beneficiary under the same rule that would govern if the benefits were still coming from the qualified plan. Therefore, if the qualified plan required the benefits to be paid out under the 5-year rule, the IRA must provide the same. However, there is an exception to this rule under IRS guidance. If a participant dies before required to take distributions and the 5-year rule applies under the plan because it is specified in the document or the participant elected it, the nonspouse may take distributions from the IRA under the life expectancy rule if the rollover is made prior to the date the first required distribution must be made (the end of the year following the year of death). However, if the rollover is completed in the year following the year of death, the beneficiary can still elect the life expectancy payout, but there is a taxable required minimum distribution for such year under the life expectancy rule. Therefore, to ensure the beneficiary pays no tax on a rollover under the life expectancy rule, the rollover must be made in the year of death.

While the PPA provision may avoid immediate taxation of a lump sum distribution to a nonspouse beneficiary, it does little else and spouses still rule...

Many retirement plans require survival benefits to be paid in a lump sum distribution. IRS guidance speaks in terms of a plan adopting a provision "specifying the 5-year rule". While providing for a lump sum distribution does not "specify the 5-year rule", a lump sum distribution meets the 5-year rule. Therefore, the nonspouse beneficiary should be able to elect life expectancy distributions when a plan requires a lump sum distribution and permits a direct rollover to an IRA, provided the rollover is made timely.

While the PPA provision may avoid immediate taxation of a lump sum distribution to a nonspouse beneficiary, it does little else and spouses still rule when it comes to minimizing income tax on retirement benefits at death.

Scott E. Galbreath, J.D., LL.M. (Taxation) is a partner in the transactional group. Contact Scott at 312.621.4400 or at SGalbreath@snsfe-law.com to learn how SNSFE can improve the design of your employee benefits plan or help you meet your company's benefits goals.

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Spotlight on: Securities Practice Group

News on our securities team led by James J. Eccleston:

- They recently secured a substantial award for compensatory damages for a broker client against Wachovia Securities for wrongful termination and defamatory Form U-5 filing.
- James Eccleston has a new blog at financialcounsel.typepad.com featuring podcasts and written commentary on financial counsel and intelligence for investors and investment professionals. He is the legal columnist for *Chicago Daily Law Bulletin, Chicago Lawyer* and numerous other publications. *Research Magazine* published one of his articles in their recent March issue.

For more information on the securities team, contact James Eccleston at 312.621.4400 or JEccleston@snsfe-law.com.

upcoming events

Call 312.621.4400 for more information.

See a full listing of upcoming events on our website at www.snsfe-law.com.

Webinar: May 8
Don't Be Rolled Over By Your Rollover! New Considerations For Planning Your Retirement Plan Distribution Options
Scott E. Galbreath, J.D., LL.M.
11:30 AM - 12:00 PM. Complimentary. Online and phone.

Seminar: June 28
3rd in a series of quarterly breakfast seminars designed for business owners and senior level executives.
Speaker TBD. Information will be posted on our website as it becomes available.
7:30 AM - 9:00 AM. Complimentary. National Bank of Commerce, 1640 W. Lake St., Addison.

Webinar: July 11
Title/topic TBD
Ronald M. Amato, J.D.
11:30 AM - 12:00 PM. Complimentary. Online phone.