Legal Issues That Affect Awards Programs 2017 Primer

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1. EMPLOYEE ACHIEVEMENT (SAFETY AND SERVICE) AWARD PROGRAMS

Section 274(j) of the Internal Revenue Code (the "Code") contains specific rules on the tax treatment of "**employee achievement awards**." Generally, if "employee achievement awards" meet certain statutory criteria, the employer may deduct the cost of the awards as an administrative expense, but the awards are not taxable to the employee. Code section 274(j) defines an employee achievement award as an item of "**tangible personal property**" that an employer gives to an employee for length of service or safety achievement. The award must be given as part of a meaningful presentation and under such conditions that it does not amount to disguised compensation. For example, an incentive award will not qualify for favorable tax treatment if it is given at the same time that annual salary adjustments are made, or if it is used as a substitute for a program of awarding cash bonuses. If certain other statutory conditions are met, an employer may deduct the cost of employee achievement awards given to the same employee up to **$400** in any year as an administrative expense. If the employee achievement awards are given under an employer's qualified plan (*i.e.*, a written plan or program that does not discriminate in favor of highly compensated employees as to eligibility or benefits), the $400 deduction limitation is increased to **$1,600** per employee. The average cost per employee of all employee achievement awards given pursuant to all of the employer's established written plans during any given year cannot **exceed $400**, however.

If an award is one of "nominal value," its cost is excluded from the calculation of the total amount of incentive awards given under established ***written plans or programs*** in any year. The IRS has not said what constitutes nominal value for these purposes, but most experts believe that up to $50 is of nominal value, while others assert that an award of up to $100 should be treated as one of nominal value.

Tangible personal property excludes certain items. Accordingly, an incentive award cannot be in the form of cash or a gift certificate (other than a **non-negotiable** certificate conferring only the right to receive tangible personal property). Any certificate that may be converted to cash is not "tangible personal property" and cannot qualify for preferential tax treatment. Other items that are not tangible personal property include travel, vacations, meals, lodging, tickets to theater or sporting events, and stocks, bonds, or other securities. The fair market value of incentive travel awards given to employees is ***taxable*** as additional income to them and deductible by the employer as compensation paid.

A length of service award can be excluded from an employee's income only if it is received by the employee after his first five years of service with the employer giving the award, and then only if the employee has not received another length of service award from his employer for at least five years. An award for safety achievement can be excluded from an employee's income only if that employee is a full-time employee (other than a manager, administrator, clerical worker or other professional employee), and then only if during the taxable year all other employee awards for safety achievement have previously been made to 10% or less of the eligible full-time employees of the employer, excluding awards that are not taxable because they are *de minimis* fringe benefits. Once the 10% limitation is exceeded in any given year, the employer may not deduct the cost of any subsequent safety achievement awards as an administrative expense. Because the award would be taxable to the employee as additional compensation, however, the employer may deduct it as such.

The rule that an award for safety achievement can be made be nontaxable to up to 10% of eligible employees only has created a lurking problem for employers and employees under the Fair Labor Standards Act (FLSA), if the employer does not structure its safety incentive program properly. The FLSA and its regulations generally consider prizes awarded for perfect attendance or safety records as additional remuneration for employment and require that their value be rolled back into the employees' regular rate of pay for overtime purposes. For example, if an employee can earn some prize automatically by attending safety meetings or by having a perfect safety record over a period of time such as one month, the prizes would probably be treated as additional remuneration earned by the employee for his employment. Therefore, if an employee works a substantial amount of overtime, this additional remuneration that an employee will be deemed to have earned may require the company to pay him or her extra overtime. One exception to this rule is if the granting of the prize or award is pursuant to a drawing (a lottery or game of chance) where an employee's chances of winning the prize are small. The exception would not apply to most safety incentive programs, however, as they are structured to include a substantial number of employees (up to 10% of eligible employees). Thus, it becomes very important for an incentive firm and employer to structure a safety incentive program so that it fits within the requirements of Code section 274(j), especially at companies where employees work considerable amounts of overtime. (The FLSA does not create any special problems where employees work little or no overtime.)

As long as the merchandise that the employee receives for safety achievement satisfies specific rules of Code section 274(j), it would not be taxable as compensation for income and payroll (FICA) tax purposes. Similarly, the safety achievement award should not be deemed to be additional remuneration for employment for purposes of the FLSA. The most common pitfalls for safety achievement plans is that awards may sometimes be given to more than 10% of eligible employees, or that the awards are not merchandise or other tangible personal property (they are, for example, travel, vacations, meals, lodging, tickets to theater or sporting events, and the like). Incentive firms should be extremely careful that safety achievement awards qualify for preferential tax treatment under Code section 274(j), or the employer may have to treat the award as additional compensation and be liable for additional overtime to its employees under the FLSA, and the employee may be required to include the award in his or her income.

Furthermore, many employers use taxable performance award programs in addition to non-taxable safety and/or service award programs. Taxable programs are established to reward various types of behavior and/or to acknowledge the achievements of individual employees and teams of employees in reaching certain goals or targets. When employers use taxable and non-taxable programs (*i.e.*, safety and service award programs), they should be careful to keep the two programs separate. If the two programs are mingled together, the employer would incur a substantial risk that the safety and service award programs would be treated as part of the overall performance award program and, therefore, taxable. Accordingly, employers and their incentive partners should make sure that safety and service award are established and operated separately from any taxable programs they may have.

POTENTIAL LEGAL ISSUES INVOLVING EMPLOYEE ACHIEVEMENT AWARD PROGRAMS

Incentive companies and their employer clients should not face too many hurdles under Code section 274(j) or any other statute when operating a length of service award program. The most important requirement for a length of service award under section 274(j) is that it can be excluded

from an employee's income only if it is received by the employee after his first five years of service with the employer giving the award, and then only if the employee has not received another length of service award from his employer for at least five years.

Safety achievement award programs are much more problematic. Like service award programs, the award must be in the form of tangible personal property, which means it must be merchandise. Accordingly, the award **cannot** be in the form of cash or a gift certificate (other than a non-negotiable certificate conferring only the right to receive tangible personal property). Any certificate that may be converted to cash is not "tangible personal property" and cannot qualify for preferential tax treatment. Other items that are not tangible personal property include travel, vacations, meals, lodging, tickets to theater or sporting events, and stocks, bonds, or other securities. Moreover, the employer can give a safety achievement award to 10% or less of its eligible full-time employees.

If an employee achievement award does not meet the statutory requirement of Code section 274(j), the value of the award may be treated as additional remuneration for employment under the Fair Labor Standards Act ("FLSA"). Incentive companies should be extremely careful that safety achievement awards qualify under Code section 274(j), or the employer may have to treat the award as additional compensation and be liable for additional overtime to its employees under the FLSA. (The same potential concern exists for service award programs, but there are fewer legal requirements for an employer to meet in order to have a service award program qualify under Code section 274(j).)

Finally, the Occupational Safety and Health Administration ("OSHA") does not understand or like safety incentive programs. Thus, employers and incentive companies need to take care in the way they design safety incentive programs to avoid running afoul of OSHA rules. In the preamble to a recently adopted final rule on record keeping and reporting of accidents, OSHA states that the rule does not prohibit safety incentive programs. The rule does restrict the use of safety incentive programs, however, and provides examples of programs that comply with the rule and those that do not.

OSHA states that an employer would violate the rule if it were to take adverse action against an employee for reporting a work-related injury or illness, regardless of whether such action is part of an incentive program. For example, a safety incentive program that disqualifies an employee from receiving a bonus or award because the employee reported a work-related injury or illness would violate the rule because OSHA deems the denial of a bonus or award to be an adverse job action. Additionally, it believes that such a safety incentive program would deter or discourage a reasonable employee from reporting a work-related injury or illness. There are certain types of safety incentive programs that OSHA deems compliant. For example, if an incentive program makes an award contingent upon whether employees correctly follow legitimate safety rules such as wearing hard hats or protecting themselves from falls, rather than whether they reported any injuries or illnesses, the program would comply with the final rule.

The line between safety incentive programs that OSHA favors and those it does not is far from clear. Moreover, it is unclear if the final OSHA rule on record keeping and reporting of accidents would survive judicial scrutiny. For now, it provides another trap for the unwary and another potential hurdle in whether an employer would use a safety incentive program at all.

2. INVESTMENT ADVICE FIDUCIARY RULE

The Department of Labor ("DOL") issued a new rule that is scheduled to be phased in between April 10, 2017 and January 1, 2018 that expands the "investment advice fiduciary" definition under the Employee Retirement Income Security Act of 1974 ("ERISA"). The new fiduciary rule is intended to elevate all financial professionals who work with retirement plans or provide retirement planning advice to the level of a fiduciary and require him or her legally and ethically to meet the standards of fiduciary status. While the new rules are likely to have at least some impact on all financial advisors, its greatest impact would appear to fall on those who work on commission, such as brokers and insurance agents.

The current status of the fiduciary rule is uncertain, however, because President Trump issued an executive order and a draft presidential memorandum on February 3, 2017 instructing the DOL to conduct "economic and legal analysis" on the rule's potential impact. If the DOL were to conclude that the fiduciary rule does hurt investors or firms, it can propose a rule "rescinding or revising" it. The presidential action will most likely delay the implementation of the rule by 180 days. It is nonetheless important to understand the fiduciary rule because, after several years of preparing for it, many mutual funds and other investment companies are in the process of complying with it regardless. Indeed, not only is there considerable momentum in favor of compliance within the finance industry, but the public supports the additional investor protections, as well.

The new rule's definition of a fiduciary demands that advisors act in the best interests of their clients and put their clients' interests above their own. It leaves no room for advisors to conceal any potential conflicts of interest, and it states that all fees and commissions must be clearly disclosed in dollar form and amount to clients. The definition of a fiduciary has been expanded to include any professional making a recommendation or solicitation, and not simply giving ongoing advice. Previously, only advisors who were charging a fee for service (either hourly or as a percentage of account holdings) on retirement plans were considered fiduciaries.

The "fiduciary" standard is a much one than the "suitability" standard that had previously been required of financial salespersons, such as brokers, planners and insurance agents, who work with retirement plans and accounts under ERISA. Under a "suitability" standard, if an investment recommendation met a client's defined need and objective, it was deemed appropriate. Now, financial professionals are legally obligated to put their clients' best interests first rather than simply finding "suitable" investments. While the new rule could therefore eliminate many commission structures that govern the industry, it should not be objectionable to obligate a broader category of financial professionals to put their clients' best interests first, as they should have been doing so all along. Stated differently, investment recommendations that were deemed suitable as a matter of law were often ill-suited in fact to the needs of the client.

Financial advisors who wish to continue working on commission will need to provide clients with a disclosure agreement, called a "Best Interest Contract" ("BIC") exemption in circumstances where a conflict of interest could exist (for example, the advisor receives a higher commission or special bonus for selling a certain product). The BIC exemption document is essentially a disclosure agreement that an advisor must provide to clients that would permit the advisor to offer products or strategies that could potentially have conflicts of interest and may not be considered to be in the best interests of the client.

If a financial advisor is to earn commissions that vary by product, the transaction would need to qualify under the BIC exemption. This is to guarantee that, as a client's fiduciary, the advisor is working unconditionally in the best interest of the client. The BIC exemption would permit firms to use many of their current compensation models if they acknowledge their fiduciary status, give prudent and impartial advice, disclose potential conflicts of interest and information about their revenue model, avoid misleading statements and receive no more than reasonable compensation. Most importantly, all compensation that is paid to the fiduciary must be clearly spelled out. The sale of variable annuities and fixed-indexed annuities to ERISA plan accounts and IRAs is allowed under the fiduciary rule only through the BIC exemption. That is also the case for advice provided to small 401(k) plans.

There are different types of BICs, depending on the recipient. For example, if a financial advisor provides advice to IRAs and plans that are not qualified under ERISA, the BIC would need to be more comprehensive, and this arrangement implies that a fiduciary relationship must be in effect before the parties execute any advisory agreement. Moreover, there must be an agreement reflecting the relevant standards for advice, and containing disclosures with respect to compensation and any related conflicts. The BIC provides for mandatory arbitration in individual disputes, but it also retains a client's right to participate in class action litigation against a financial advisor.

On the other hand, if a financial advisor provides advice to ERISA plans, the advice given under such plans is already subject a fiduciary standard. Therefore, financial advisors would not be required to sign a written contract. A written statement setting forth compensation and the advisor's fiduciary status would be sufficient. Moreover, financial advisors would also be required to provide the same disclosures on compensation and potential conflicts as in the more comprehensive BIC.

The final version of the fiduciary rule added a provision for level fee fiduciaries, as well. This deals specifically with recommendations that clients roll their 401(k) balance to an IRA account under a level fee arrangement. The BIC exemption would be more streamlined; it would have to document the reasons the rollover is deemed to be in the best interest of the client. It would also apply in the case where the client will be moved from a commission arrangement to a level fee arrangement. In order to move a client into an advisory relationship, the advisor would need a BIC covering the higher ongoing fee. This more streamlined BIC would require advisors to provide a written statement of fiduciary status and a written rationale explaining the reasons that their recommendation would be in the best interest of the client. There would be no need for other disclosures, however, under this type of BIC exemption.

POTENTIAL LEGAL ISSUES INVOLVING THE FIDUCIARY RULE AND AWARD PROGRAMS

The DOL has advised that financial institutions may continue to use incentive compensation and awards for their financial advisors and still comply with the BIC exemption. The DOL strongly cautioned, however, that any such arrangements must be carefully structured and monitored to avoid creating, or allowing the continuation of, incentives for financial advisors to act in a manner that would not be in the best interest of the retirement investor.

Moreover, henceforth, it would be improper to base incentives to financial advisors on the relative profitability to the financial institution of certain products. For example, a financial institution should not pay an advisor a higher commission for selling a particular mutual fund as compared to another such fund if the two funds are similar products but the former has a higher payout to

the financial institution. Incentives should be based upon "neutral" factors, such as the amount of work involved or other factors justifying distinctions in the amount of compensation payable to a financial advisor for selling certain categories of products.

Finally, the DOL has cautioned that any volume-based incentive grids should not include provisions that might tempt financial advisors to act imprudently. For example, increases in payout percentage as the advisor progresses up the grid should be "modest," and there should be no retroactive application of higher payout percentages to transactions completed before (s) he qualifies for the higher payout level.

As a result of the new fiduciary rule, many financial institutions appear to be shying away from using any type of incentive or award program to motivate and/or compensate their employees. Given the level of uncertainty surrounding the fiduciary rule, they are concerned that any awards or incentives could potentially be deemed to run afoul of BIC exemptions. Although this is an overreaction, it is understandable in the context of the old days when conflicts were rife, as fund companies competed to encourage brokers and advisors to put people in their funds, regardless of what was in the clients' best interest. Mutual fund companies also compensated intermediaries with trips to exclusive destinations and other lavish prizes. They also shared revenues with brokers. For example, Franklin Templeton paid $31.1 million and American Funds paid $55 million in revenue sharing to Edward Jones as recently as in 2015. *See* Leslie Norton, "The Fiduciary Rule Still Has Momentum," *Barron's*, February 6, 2017, at 38. Until there is greater certainty on how the fiduciary rule will be applied, financial institutions may end up using fewer award and incentive programs.

3. GIFT CARDS

A. OVERVIEW

A gift certificate is a written or electronic instrument for which the issuer has received payment for its total face amount in exchange for allowing the purchaser to redeem such certificate in the future for goods or services. Many states have no specific requirements for issuing gift certificates, but several states have rules regarding the use of expiration dates, dormancy and other administrative fees, the maintenance of records regarding gift certificates, and the disclosure of certain information about the certificates. In addition, all states have escheat laws, and gift certificates are subject escheat in many states. In the simplest terms, "escheat" refers to the process through which property that is, or is deemed to be, unclaimed or abandoned becomes property of the state after a certain period of time, typically between three and seven years.

The Supreme Court has announced two rules that govern a state's right to escheat. The primary rule of escheat is that where intangible property such as a debt is involved, its situs should be the legal location of the laws by which intangible property may be treated or enforced. Therefore, the first priority rule of escheat is that a debt should escheat to the state of the creditor's last known address, because a debt is intangible property that belongs to a creditor. *See Texas v. New Jersey*, 379 U.S. 674, 680 (1965). Accordingly, a gift card would escheat to the state of the last known address of the holder, who is the creditor. If there is no last known address for the creditor (most likely because the gift card issuer and/or seller does not keep records of who has purchased or received a card), under the court's second priority rule, the funds would escheat to the state of incorporation of the debtor. *See Pennsylvania v. New York*, 407 U.S. 206 (1972).

Some states have asserted that if the first two jurisdictional rules do not apply, a third priority rule should apply. This rule would permit the state where the transaction (the purchase of the gift card) occurred to apply its escheat rule. The U.S. Supreme Court has not specifically recognized this so-called third priority rule. Furthermore, in many cases it may not be known where the transaction occurred, or the transaction may be deemed to have occurred where the issuer is located. Therefore, under current law, when the holder of a gift card is unknown and the issuer's state of incorporation or formation exempts gift cards from escheat, the issuer may be able to avoid escheat. Nevertheless, some states appear poised to attempt to impose the transactional rule in a case where the first two jurisdictional rules of escheat do not apply, and the gift certificates would not escheat to any state. At this time, however, it does not appear that the transactional rule is a valid escheat priority rule, and it has not been recognized as such by any federal appeals court. Moreover, one federal appeals court has specifically declined to create a third priority rule based on place of purchase. *New Jersey Retail Merchants Association v. Sidamon-Eristoff*, 669 F.3d 374 (3d Cir. 2012), *aff'g* 755 F. Supp. 2d 556 (D.N.J. 2010).

B. FEDERAL LEGISLATION

The Credit Card Accountability Responsibility and Disclosure Act of 2009 (the "CARD Act") made significant changes to the way that credit card companies transact business. In many respects the CARD Act provides a bill of rights for everyone who uses credit cards. Less noticed at the time, was that the CARD Act also contained provisions governing gift cards, including restrictions on the use of expiration dates and the use of dormancy and other fees. The CARD Act states that most types of gift cards cannot expire for the fist five years after issuance, and dormancy and other fees cannot be imposed unless there has been no activity with respect to the card for 12 months. The CARD Act obligated the Federal Reserve to promulgate rules to apply and administer the Act. The Federal Reserve promulgated such rules effective on August 22, 2010 (the "Rules").

The definitions of a gift certificate, store gift card, and general-use prepaid card under the CARD Act include almost every gift card and similar prepaid payment device. Section 915(a)(2)(D) of the CARD Act and section 205.20(b) of the Rules specifically exclude various types of cards, codes, or other payment devices from the definition of gift certificates, store gift cards, and general-use prepaid cards, however. Thus, the Rules do not apply to a card, code, or other device that is:

1. Useable solely for telephone services;
2. Reloadable and not marketed or labeled as a gift card or gift certificate;
3. A loyalty, award, or promotional gift card;
4. Not marketed to the general public;
5. Issued in paper form only; or
6. Redeemable solely for admission to events or venues at a particular location or group of affiliated locations, or to obtain goods or services in conjunction with admission to such events or venues, at the event or venue or at specific locations affiliated with and in geographic proximity to the event or venue.

The first and last exclusions are self-explanatory. Those listed in (ii) through (v) may be more important to merchants and the public. The exclusions for a gift card that is "reloadable and not marketed or labeled as a gift card or gift certificate" or a "loyalty, award, or promotional gift card" deserve special mention because they are among the most important exceptions to the application of the Rules.

The exclusion for reloadable cards not marketed as gift cards may be important because many prepaid card issuers have begun to de-emphasize marketing their products primarily as "gift" cards in order to emphasize the uses for these products besides gifting. For example, whether a card is for general use or specific to a merchant, one of the primary uses of prepaid cards is to allow consumers who do not have traditional bank accounts to make purchases on-line. Prepaid card issuers who are moving away from the "gift" label anyway may decide that this exclusion provides a good way to avoid application of the Rules.

The Commentary provisions to section 205.20(b)(2) of the Rules interpret this exclusion narrowly, however. An issuer or seller might not be able to rely on this exclusion simply by avoiding the word "gift" on the card and in marketing materials. The Commentary provides that the term "marketed or labeled as a gift card or gift certificate" means "directly or indirectly offering, advertising or otherwise suggesting the potential use of a card, code or other device, as a gift for another person." Thus, issuers and sellers will have to be careful when describing the fact that a card is transferable; otherwise they may be accused of indirectly suggesting that the card might be given as a gift. Moreover, the Commentary states that if any person in the distribution chain markets or labels the card as a "gift" card, everyone loses the protection of this exclusion with respect to the card. This means, for example, that issuers need to ensure that retailers that sell the cards do not market or label them as "gift" cards. Retailers may need to replace or cover up the signs that say "gift cards" above the prepaid card racks. If gift cards and prepaid cards are promoted and sold in the same store, the key consideration would be whether a reasonable consumer could be led to believe that all certificates or cards referenced in an advertisement are gift certificates or cards.

Commentary section 205.20(b)(2)-4 of the Rules provides a safe harbor that a reloadable card is not marketed or labeled as a gift card or certificate if companies that sell them "maintain policies and procedures reasonably designed to avoid such marketing." Such policies would include contractual provisions prohibiting a general purpose reloadable card from being marketed as a gift card and controls to monitor regularly or verify in some other manner that the cards are not being marketed as a gift card. One example that the Commentary gives of such policies and procedures is where the issuer or program manager sets up two physically separate displays at a retailer, one for gift cards and the other for reloadable cards that are not marketed as gift cards.

The exclusion for loyalty, award, or promotional gift cards is the most important one for rewards and recognition marketplace. Section 205.20(a)(4) of the Rules defines the term as a card, code, or other device that (i) is issued on a prepaid basis primarily for loyalty, award, or promotional purposes to a consumer in connection with a loyalty, award, or promotional program, (ii) is redeemable upon presentation for goods or services or can be used at an automated teller machine, and (iii) contains various disclosures, including, a statement indicating that it is issued for loyalty, award, or promotional gift purposes (on the front of the card), the expiration date (on the front of the card), the fees that may be charged and the conditions under which they may be imposed, and a toll-free number and, if one is maintained, a Web site that a consumer may use to obtain information on fees and other conditions. The fees do not need to be stated on the loyalty, award, or promotional gift card itself. Thus, a loyalty, award, or promotional gift card <u>must</u> contain any expiration date on the front of the card as well as the term "Reward," "Promotional," or some other similar term.

In the preamble to the Rules, the Fed specifically rejected arguments that the disclosure requirements and the use of the term "Reward" or "Promotional" on a card would be too onerous

for many merchants that use the same standard design for closed loop gift cards they sell to the public and those that they sell to businesses for distribution as reward or loyalty cards. The Fed asserted that the benefits of standardization are outweighed by "consumer confusion because cards that otherwise appear to be the same may carry terms and conditions, including fees and expiration terms, that vary to a significant degree."

In contrast to gift cards that a consumer may purchase at a store or on-line, loyalty, award, or promotional gift cards are typically funded or purchased by a merchant, employer, or some other company that sponsors the gift card program. This type of card is a good and cost-effective substitute for traditional means of distributing funds through a promotion. Commentary section 205.20(a)(4)-1 of the Rules lists several examples of loyalty, award, or promotional gift cards. They include cards issued pursuant to consumer retention programs, sales promotions, rebate programs, sweepstakes programs, customer referral programs, employee incentive programs, and charitable or community relations programs. These examples do not contain any surprising or controversial type of loyalty, award, or promotional gift card, with the possible exception of rebate cards, which have not been considered normally to be loyalty, award, or promotional gift cards.

The Commentary provisions to section 205.20(b)(4) interpret the exclusion for cards, codes, or other devices that are not marketed to the general public fairly narrowly. Whether the card is marketed to the general public would depend on the facts and circumstances of each transaction, but the term generally refers to a card that is not directly or indirectly offered, advertised, or otherwise promoted to the public through any advertising medium including television, radio, newspaper, the Internet, and signage. The Rules list several factors to consider in determining if a card is marketed to the public, including the means by or channel through which the card may be obtained, the group or subset of consumers who may obtain the card, and whether the availability of the card is advertised or promoted in the marketplace.

Commentary section 205.20(b)(4)-2 of the Rules provides several examples illustrating the application of this exclusion. For example, if a bank sells a gift card to its customers, and if any member of the public may become a customer of the bank, then the card is deemed to be marketed to the public, and the exclusion does not apply. Similarly, if an issuer advertises a reloadable card for use by teenagers to pay for occasional expenses, schoolbooks, and emergencies, and by their parents to monitor spending, it would be deemed to be marketed to the public if anyone can buy it, and the exclusion does not apply. An example of a card that is not marketed to the public is one that is issued by a merchant for store credit to a consumer who has returned merchandise. Such a card would not be advertised or marketed to the public. An interesting example of how the exclusion might create a trap for the unwary is the use of a prepaid card by a tax preparation company to distribute refunds to its clients. Such a card would not be deemed to be "marketed to the general public" if it is simply the mechanism for the refund, and the preparer does not advertise its ability to obtain refunds by a prepaid card. If the preparer advertises its ability to receive tax refund proceeds through a prepaid card as a means of obtaining "faster" access to the tax refund proceeds, then the card is deemed to be marketed to the public, and the exclusion does not apply.

Anyone who wishes to avoid the application of the CARD Act can also take advantage of the exclusion for gift cards, codes or devices that are issued in paper form only. The exclusion is fairly self-explanatory. Under section 205.20(b)(5) of the Rules, the exclusion applies only if paper is the ***sole*** means for issuing the gift card or certificate. Thus, for example, a paper certificate that a

restaurant issues for a meal or a paper receipt for a car wash that a merchant issues with a numerical or bar code would qualify for the exclusion. While this example is not in the Commentary to the Rules, the exclusion should also apply to a paper certificate or voucher that an employer might give to an employee redeemable for one or more items of merchandise. Note, however, that if an on-line merchant sends an electronic message providing a numerical or bar code, a certificate or card number, or a coupon that can be printed on a printer, the exclusion does not apply because it the card or certificate was sent in electronic form. The fact that the consumer would most likely print the card or coupon before using it is immaterial. Therefore, an electronic gift certificate could not qualify for this exclusion. Commentary section 205.20(b)(5)-2 of the Rules provides several examples of gift cards that are issued in paper form only.

The CARD Act preempts state law partially. As a practical matter, partial federal preemption means that states may not provide less consumer protection, but they may provide more. Generally speaking, states may not regulate cards issued by banks. For those types of cards, federal preemption is absolute. Any issuer of gift cards must now be mindful of the CARD Act as well as any state laws that might apply.

C. ADMINISTRATIVE/DORMANCY FEES AND EXPIRATION DATES

Some gift certificate issuers seek to avoid the escheat issue by charging monthly, or less frequent dormancy or administrative fees that eliminate any unused portion of a gift certificate. The issuers argue, with some justification, that such administrative fees are equivalent to usage of the certificate and either reduce the amount or leave no amount that may escheat to the state. Before an issuer imposes administrative fees, however, it should review very carefully applicable state escheat laws for restrictions on such fees.

Several states prohibit dormancy and related fees completely while others permit them only after the passage of a certain period of time. In addition, the CARD Act imposes various rules regarding dormancy periods. For example, Section 205.20(d) of the Rules the Federal Reserve has adopted to implement the gift card provisions of the CARD Act (the "Rules") prohibits any person from imposing a dormancy, inactivity, or service fee with respect to a gift card unless all of the following requirements are satisfied:

> (1) There has been no activity with respect to the gift card for the one-year period ending on the day the charge is imposed;
> (2) The following are stated, as applicable, clearly and conspicuously on the gift card:
> > (i) The amount of any dormancy, inactivity, or service fee that may be charged;
> > (ii) How often such fee may be assessed; and
> > (iii) That such fee may be assessed for inactivity; and
>
> (3) Only one such dormancy, inactivity, or service fee is imposed in any given calendar month.

Thus, if a consumer buys a gift card on January 15, 2011 and there has been no activity on it for one year, a dormancy, inactivity, or service fee may be imposed on the gift card on January 15, 2012. The earliest date another such fee may be imposed is February 1, 2012. If the holder uses the card to make a purchase on January 31, 2012, however, no additional fee may be imposed until January 31, 2013.

It is worth noting that the federal dormancy fee rules that the CARD Act enacted are the minimum protection that an issuer must provide. If a state provides stronger consumer protections, *i.e.*, it

either prohibits dormancy fees altogether or permits them only after the passage of a longer period of time, then the state law would govern. Cards issued by banks are governed solely by federal law. Therefore, dormancy fees on bank-issued cards need not comply with state laws.

Most states now prohibit the imposition of expiration dates on gift cards. As with dormancy fees, Section 205.20(e) of the Rules prohibits any person from selling or issuing a gift card with an expiration date, unless the following requirements are satisfied:

(1) The person has established policies and procedures to provide consumers with a reasonable opportunity to purchase a gift card with at least five years remaining before the gift card (as opposed to the underlying funds) expires;
(2) The expiration date for the underlying funds (as opposed to the expiration date for the gift card itself) is at least the later of: (i) five years after the gift card was issued initially or funds were last loaded; or (ii) the gift card expiration date, if any;
(3) The following disclosures are provided on the gift card, as applicable:
(i) The expiration date for the underlying funds or, if the underlying funds do not expire, that fact;
(ii) If the underlying funds might expire after the gift card itself, a toll-free telephone number and, if one is maintained, a Web site that a consumer may use to obtain a replacement gift card after the gift card expires; and
(iii) Except where a non-reloadable certificate or card bears an expiration date that is at least seven years from the date of manufacture, a statement, disclosed with equal prominence and in close proximity to the gift card expiration date, that: (A) the gift card expires, but the underlying funds either do not expire or expire later than the gift card; and (B) the consumer may contact the issuer for a replacement gift card; and
(4) No fee or charge will be imposed on the cardholder for replacing the gift card or for providing the gift card holder with the remaining balance in some other manner prior to the expiration date for the underlying funds, unless the gift card has been lost or stolen.

Thus, if state laws permit expiration dates that are less than five years, federal law preempts them. If a state provides stronger consumer protections, *i.e.*, it either prohibits expiration dates altogether or permits them only after the passage of a longer period of time (for example, seven years in Massachusetts), then the state law would govern. Cards issued by banks are governed solely by federal law, meaning that expiration dates on bank-issued cards need not comply with state laws.

D. CASH REFUND REQUIREMENT

Another trend that has begun to surface over the last few years is "upsales" involving gift cards. Indeed, one of many reasons that gift cards continue to gain popularity is that merchants have come to expect that customers will spend more than the face amount of the card once in the store. As a result, several states have enacted legislation that would require the gift card issuer to provide cash back to holders in certain cases. So far, there are ten states that have such laws in effect, California, Colorado, Maine, Massachusetts, Montana, New Jersey, Oregon, Rhode Island, Vermont, and Washington.

California is the state with the most generous statute requiring cash back to a holder. A gift card issuer is required to provide cash back to gift card holders for any card with a remaining value of ***$10 or less***. The cash redemption right does not apply to certificates that are (1) distributed by an issuer to a consumer pursuant to an awards, loyalty, or promotional program, as long as the consumer does not give money or any other thing of value in exchange for the gift certificate,

(2) sold below face value at a volume discount to employers or to nonprofit and charitable organizations for fundraising purposes if the expiration date on those certificates is not more than 30 days after the date of sale, or (3) sold for food products such as groceries (this exception does not apply to gift certificates for restaurant meals).

Colorado provides that a consumer may elect to receive cash if the card balance is $5.00 or less, Maine, if the card balance is less than $5.00, Montana, if the remaining value of a certificate is less than $5.00 (if the original value of the certificate had been more than $5.00), New Jersey, if the card balance is less than $5.00, Oregon, if the card balance is less than $5.00, Rhode Island, if the card balance less than $1.00, Vermont, if the remaining value is less than $1.00, and Washington, if the card balance is less than $5.00. Massachusetts law provides that if 90 percent or more of a gift certificate has been used, the consumer may elect to receive cash for the balance.

Washington law on the subject of cash redemption is anything but clear regarding whether the state imposes a cash redemption right for gift certificates. It may be argued that cash redemption is required only if dormancy fees are imposed, but a better interpretation of the statute is that it requires cash redemption in all cases. The statute provides that gift cards may contain dormancy fees if (1) the value remaining on the gift card is $5.00 or less each time the fee is assessed, (2) the dormancy fee is $1.00 per month or less, (3) the card has been inactive for 24 consecutive months (for example, no purchases, "reloading," or balance inquiries), (4) the holder may reload or add value to the card, and (5) the card contains a statement in at least 6-point type stating the amount and frequency of the fee, that the fee is triggered by inactivity, and at what point the fee will be charged, and (6) ***after a dormancy fee is imposed, the remaining value of the certificate is redeemable in cash on demand***. Except in the narrow circumstances listed above, in (1) through (6), expiration dates and dormancy fees are not permitted. In addition, gift cards may contain expiration dates and dormancy fees if (a) they are distributed by an issuer pursuant to an awards, loyalty, or promotional program, as long as the recipient does not give money or any other thing of value in exchange for the gift certificate, or they are donated to charity to be used solely to provide charitable services; (b) they are donated to charity for use in its fundraising, as long as the expiration date is at least one year from the date they are issued by the charity; or (c) they are redeemable for goods or services provided in the state by artistic and cultural organizations.

If the certificate contains a dormancy fee, Washington law creates a right to redeem it for cash if its value is $5.00 or less. Even if a certificate has no dormancy fees, however, Washington law appears to require a right of cash redemption. It would be prudent to permit a cash redemption right to consumers whenever the value of a gift card is no more than $5.00.

While the cash redemption trend may be an understandable effort to protect consumers from themselves, it is sure to create a great deal of extra work and potential problems for merchants. The new California law is especially noteworthy in that California tends to be very extra-territorial in applying its laws. In the past, the state has asserted that its law would apply in the following contexts: (a) if a product is bought outside the state and sent to a resident as a gift, (2) if a product is bought from a resident and sent to another state, or (3) if someone bought a product from one state (for example, New York) and sent it to another state (perhaps Virginia), and the transaction took place in California through a telephone operator or computer server. Thus, merchants may be required to apply California law requiring a right of cash redemption even if the connection with that state is remote or tangential. Moreover, the requirement that the merchant provide

cash back if the value of the card falls under $10.00 could create a problem for merchants if low-denomination gift cards are purchased with stolen credit cards and redeemed after a small purchase. For those that resell their cards, they also face the prospect of paying commissions on the full face amount of the card when they may have collected something less than that amount in the original sale. All in all, the new trend bears watching, as it may create more unforeseen problems for merchants in the name of consumer protection.

E. WHEN GIFT CARDS ARE NOT SUBJECT TO ESCHEAT IN A STATE

A large majority of the states exempt gift cards from their escheat statutes, at least if the card has no expiration period or no more than a certain value. Any gift certificate that is not subject to escheat in one state, because that state exempts certificates from its escheat laws, may potentially be subject to the escheat laws of another state. Thus, for example, if the gift certificate holder's last known address is California, that gift certificate is not subject to California's escheat law. The state of incorporation or organization of the issuer of the gift certificate would claim that because California's escheat law does not apply, the gift certificate should escheat to it. If the law of the state of incorporation or organization of the issuer does not apply to gift certificates, the state of the purchaser may try to apply its escheat laws to the certificate. (This matters only if the purchaser of the certificate is not also its holder, and it is unclear whether the purchaser's state would have the right apply its unclaimed property law). With careful planning, it may be possible to avoid the escheat of gift certificates in some instances.

F. STORED VALUE CARDS ISSUED BY FINANCIAL INSTITUTIONS

Stored value and other similar prepaid debit cards issued by financial institutions are not subject to state laws that govern gift certificates or cards. The attorneys general of all 50 states wrote a letter to the U.S. Office of the Comptroller of the Currency in 2003 to protest rules that preempt state laws that purport to regulate any aspect of a national bank's activities, including gift cards, to no avail. The attorneys general were rightfully concerned that stored value and other debit cards issued by banks are not subject to any state's consumer protection laws.

Unlike other gift cards, those issued by banks impose various fees that would not be allowed under the laws of several states. Stored value and other similar prepaid debit cards are governed by federal banking laws and regulations and are beyond the reach of state regulators. Thus, the U.S. Court of Appeals for the First Circuit recently ruled that a state's attempt to impose restrictions upon a national banking product frustrates Congressional policies and goals set forth in federal banking laws and the associated regulations implemented by the Office of Thrift Supervision ("OTS") and the Office of the Comptroller of the Currency "OCC"). Therefore, federal law preempts and overrides state law, including New Hampshire's consumer protection laws. *See SPGCC, LLC v. Ayotte*, No. 06-2326 (1st Cir. May 30, 2007), *aff'g* No. 2006 WL 2165672 (D.N.H. Aug. 1, 2006).

The *SPGCC* case involved Simon Visa GiftCards sold over the Internet (by MetaBank) and in Simon Property's malls (by U.S. Bank). The Giftcards issued by U.S. Bank contained an initial $2.00 handling fee, a $2.50 monthly service fee that applies after the first 12 months, a $5.00 fee if a card is lost or stolen, and a $15.00 balance transfer or cash-out fee when the GiftCard expired. The cards issued by MetaBank are similar to those imposed by U.S. Bank (an initial $5.95 handling fee, a $2.50 monthly service fee that applies after the first 12 months, a $5.00 fee if a card is lost or stolen, and a $15.00 balance transfer or cash-out fee when the GiftCard expired). The Simon Visa GiftCards expire a minimum of 20 months after their issuance. The First Circuit held

that New Hampshire's Consumer Protection Act did not apply to the Simon GiftCards, because federal law preempts state law in this area. This is an important victory for banks and a major loss for consumers. The CARD Act now makes it explicit that federal law preempts state consumer protection law with respect to stored value cards issued by financial institutions.

G. GIFT CARD DISCLOSURES

Certain types of information should be included on all gift certificates. This includes the amount of the certificate, any restrictions on how it may be redeemed or the items it may be used to purchase, where it may be redeemed (territory and store locations, if applicable), the expiration date, and any other relevant restrictions or terms of use. If the certificate is an electronic gift/debit card, the issuer should provide the holder a means for checking the balance on the card. Gift certificate issuers might consider putting the following language on a gift certificate: (a) "Void after five years, except in states where prohibited by law," or "Void after 5 years (longer periods may apply in other states). The terms and conditions of this certificate cannot be varied except in those states that limit or prohibit expiration dates or require redemption for cash"; (b) "This gift certificate is not redeemable for cash, except as required by state"; (c) "This gift certificate will not be replaced if it is lost or stolen"; (d) a loyalty, award, or promotional gift card must contain any expiration date on the front of the card as well as the term "Reward," "Promotional," or some other similar term; and/or (e) (If desired) "This gift certificate may not be used with other coupons, discounts, or promotional offers."

POTENTIAL LEGAL ISSUES, INCLUDING ESCHEAT, INVOLVING GIFT CARDS AND AWARD PROGRAMS

There is no easy, uniform answer to questions regarding state unclaimed property laws. First and foremost, gift card issuers must determine which state's escheat law might apply. Thus, gift card issuers must be aware of the lurking jurisdictional issues and resolve each factual situation as it arises. Once an issuer has made this determination, it may consider using reasonable annual administrative/dormancy fees to reduce or eliminate the unused portion of a gift card, provided such fees are permitted by state law and comply with federal law, the CARD Act. Unless state law restricts (or prohibits) such dormancy charges, they could be an effective means of mitigating or eliminating the effect of escheat laws. The CARD Act notwithstanding, however, gift card issuers should be aware that an increasing number of states are following the lead of California and prohibiting the use of expiration dates on gift certificates.

Issuers who sell their gift cards/certificates to resellers usually do not know who has purchased or received a gift card and do not have purchaser records. Accordingly, these types of issuers may be able to avoid escheat by incorporating or organizing their business in a state that exempts gift card/certificates from its escheat laws. Regardless of where they incorporate or organize, however, most gift card issuers will still have to comply with the restrictions that the federal CARD Act imposes on the use of expiration dates and dormancy fees. Furthermore, gift card issuers must always be aware of escheat issues, because some key states have begun to amend escheat laws governing gift cards in an effort to tap into more efficiently this overlooked source of revenue.

It is worth noting that when gift cards are used as part of a loyalty, award, or promotional program, they would be exempt from the CARD Act, and they would often be exempt from state laws that limit or prohibit use of dormancy/administrative fees and expiration dates. Moreover, state laws often exempt gift cards used in loyalty, award, or promotional programs from their escheat

statutes. Therefore, gift cards that are used in such programs may carry more restrictions than those sold to consumers. Therefore, an incentive company and the employer/client should reach an understanding before the start of any award program with respect to the treatment of breakage (unredeemed gift cards) and the use of expiration dates and/or dormancy or administrative fees, and fees. Although fees and expiration dates may be permitted as a matter of law, incentive companies and their clients are likely to view fees and expiration dates issues from a different perspective.

Finally, gift card issuers should make sure that they comply with all applicable state escheat statutes, as escheat laws contain many traps for the unwary and navigating them can be fraught with risk. The look-back periods that states have for unclaimed property are often long, sometimes up to 20 years, with Delaware going back to 1981, which means that the costs of failing to comply with state escheat statutes can be high and potentially catastrophic. Over 80 percent of states conduct audits though private third-parties which have a strong incentive to assert that issuers have failed to report and pay over abandoned property because they work on a contingency basis (usually ten percent of the amount collected). If abandoned and unclaimed property has been unreported and underpaid, states will assess interest and sometimes penalties on the unreported or unpaid amounts. When one considers that breakage plays an important role in the business model of many gift card issuers and merchants, it is easy to see that dealing with escheat laws will remain vitally important for the foreseeable future.

7. FinCEN ANTI-MONEY LAUNDERING RULE AND STORED VALUE CARDS

On July 26, 2011, the Financial Crimes Enforcement Network (FinCEN) issued a rule amending the Bank Secrecy Act regulations as they applied to a money services business (MSB) with respect to stored value or prepaid access cards. The new prepaid access rule was issued under the CARD Act, which directed FinCEN to issue new rules regarding the issuance, sale, redemption, or international transport of stored value (including stored value cards). The prepaid access rule can be accessed on-line at www.fincen.gov/statutes_regs/frn/pdf/Prepaid_Final_7-22-2011.pdf. FinCEN also issued guidance in the form of Frequently Asked Questions (FAQs) November 2, 2011 explaining the application of the new rule. The FAQs titled "Final Rule – Definitions and Other Regulations Relating to Prepaid Access," can be accessed on-line at http://www.fincen.gov/news_room/nr/html/20111102.html. The new prepaid access rule went into effect on September 27, 2011. FinCEN immediately acknowledged the difficulties posed by the rule and partially delayed its compliance date until March 31, 2012 and announced that it would not initiate any compliance matter or enforcement action prior to March 31, 2012 for both providers and sellers for violations of its final prepaid access rule, nor will it assess any civil money penalties for violations that occur prior to March 31, 2012.

In general, the prepaid access rule creates a more comprehensive and intrusive regulatory framework for prepaid access products and services by expanding the parties subject to the Bank Secrecy Act to include providers and sellers of prepaid access products and services and expands the obligations of the parties involved in the distribution of such products and services. More specifically, the prepaid access rule amends the existing regulations by renaming "stored value" as "prepaid access" and defining that term, eliminating the terms "issuer" and "redeemer" of stored value cards, imposing suspicious activity reporting, customer and transaction information recordkeeping and verification requirements on providers and sellers of prepaid access, and

a registration requirement on certain providers only. Providers and sellers of prepaid access programs will also have to have in place programs to guard against money laundering, and they will also have to respond to law enforcement requests for information. The rule exempts certain categories of prepaid access cards, products, and services that pose a lower risk of money laundering and terrorist financing from various regulatory requirements.

FinCEN defines prepaid access under the prepaid access rule as "[a]ccess to funds or the value of funds that have been paid in advance and can be retrieved or transferred at some point in the future through an electronic device or vehicle, such as a card, code, electronic serial number, mobile identification number, or personal identification number." 76 Fed. Reg. 45403, 45413 (July 29, 2011). FinCEN also defines "closed loop Prepaid Access" as "[p]repaid access to funds or the value of funds that can be used only for goods or services involving a defined merchant or location (or a set of locations), such as a specific retailer or retail chain, a college campus, or a subway system." 76 Fed. Reg. at 45413. The rule applies only to "prepaid programs," which are defined as arrangements by one or more persons to provide a particular form of prepaid access. 76 Fed. Reg. at 45406-07.

After establishing the definitional framework, the prepaid access rule defines the circumstances under which various arrangements to provide prepaid access are covered by the term "prepaid program." Generally speaking, arrangements that carry a low risk of money laundering or other illegal activity would **not** be viewed as a prepaid program (which would trigger various statutory requirements). 76 Fed. Reg. at 45407. Thus, the following three types of prepaid access arrangements do would **not** constitute a prepaid program subject to the rule, regardless of their nature: (1) those that provide closed loop prepaid access to funds of no more than $2,000 on any day, (2) those that provide government funded prepaid access (for example, social security benefits, disability benefits, and disaster relief payments), and (3) those that provide prepaid access solely to funds from flexible spending arrangements for health or dependent care expenses or from health reimbursement arrangements for health care expenses. 76 Fed. Reg. at 45407-08.

There are also two types of prepaid access arrangements that have a limited or qualified exclusion. They are prepaid access to employment benefits, incentives, wages, or salaries (*i.e.*, payroll cards and the like) and open loop prepaid access to funds of no more than $1,000 and from which no more than $1,000 can be initially or subsequently loaded, used, or withdrawn on any day. These two types of prepaid access are exempt from the meaning of prepaid programs (*i.e.*, they are not subject to the regulatory requirements set forth in the rule), if certain factors that increase the risk of misuse are absent. The factors that increase the risk of misuse include (a) the transmittal of funds internationally, (b) transfers between users of prepaid access within a prepaid program, and (c) the ability to load funds from non-depository sources. 76 Fed. Reg. at 45408-09. FAQ 14 explains that, for purposes of the rule, loads that are made through a depository institution include, for example, ACH transfers from a bank account, cash or other deposit at a bank, or a check drawn on a bank and payable to the provider of prepaid access. Loads that are made through a non-depository institution would include, for example, those through retail store transactions (cash, check, or credit card), wire transfers originating at MSBs, or checks payable to a payee other than the provider of prepaid access.

The exemption for closed loop cards is the most important one for gift card issuers. In creating this exemption, FinCEN understood and accepted that closed loop cards fundamentally remain limited to their defined merchant, and they are not redeemable in cash. Closed loop access differs

considerably form open loop access (*e.g.*, debit cards), and absent very large monetary amounts, closed loop cards are unlikely to be used for money laundering or other illegal purposes. Thus, FinCEN concluded that the $2,000 threshold for closed loop cards would help facilitate commerce in the form of retail sales of consumer goods and services while mitigating the risk that these types of cards can be used for illicit purposes.

FAQ 16 clarifies that the $2,000 threshold for closed loop prepaid access applies to each device or vehicle. It does not require aggregation of all purchases of separate (distinct) closed-loop prepaid access devices or vehicles bought by an individual in a single day. As set forth below, businesses that sell more than $10,000 of any type of prepaid access to an individual in a day (whether closed or open loop) may be sellers of prepaid access under the rule, however. FAQ 17 also explains how the prepaid access rule's $2,000 daily limit applies to closed loop prepaid access that is reloadable. No more than $2,000 can be associated with each closed loop prepaid access device or vehicle in one day. As a result, if the closed loop prepaid access arrangement permits either individual reloads of more than $2,000 per device (*e.g.*, gift card), or cumulative reloads per device that total more than $2,000 in one day, the arrangement no longer qualifies for the "closed loop prepaid access" exception from the definition of a prepaid program under the rule. For example, if a closed loop prepaid access device or vehicle has a value of $1,500, and the holder spends $1,000 and subsequently reloads $600 before the end of the day, this prepaid access would fall within the definition of a prepaid program because $2,100 has been associated with the prepaid access within one day.

While the exemption for closed loop prepaid access would seem to cover many types of cards issued by legitimate retailers, especially cards sold to consumers, upon closer inspection, the prepaid access rule creates difficulties in that it regulates "Sellers of Prepaid Access" as a type of MSB. 76 Fed. Reg. at 45406. Sellers of prepaid access are deemed to be agents of an MSB and will not have to register with FinCEN as an MSB, however. *Id.* The prepaid access rule creates two circumstances under which retailers and other sellers could become a seller of prepaid access, which would require them to (i) develop and implement an effective program to prevent money laundering, (ii) make suspicious activity report ("SAR") filings, and (iii) comply with recordkeeping requirements related to customer identification information and transactional data. 76 Fed. Reg. at 45406, 45411. The customer identification and recordkeeping requirements include the name, address, date of birth, and identification number for the provider and seller of prepaid access. Providers of prepaid access must retain access to the customer data for five years after the last use of the prepaid access, and sellers must retain the customer data for five years after the sale of the prepaid access. 76 Fed. Reg. at 45413. Providers and sellers of prepaid access must also establish procedures to verify the identity of a person who obtains prepaid access under a prepaid program. *Id.*

The first circumstance is if a person receives funds or the value of funds in exchange for an initial or subsequent loading of prepaid access if that person sells prepaid access offered under a prepaid program that can be used before verification of customer information. 76 Fed. Reg. at 45412. Therefore, a person would **not** be a seller of prepaid access subject to the requirements in (i) through (iii), above, if (1) the prepaid access is not covered by the definition of a prepaid program (for example, the funds that are loaded initially are under $1,000), or (2) it includes features that would cause it to be covered by the definition of a prepaid program (for example, international use, transfers between users of prepaid access, and the ability to load funds from non-depository sources), but such features cannot be used before the seller has collected and verified customer identification. 76 Fed. Reg. at 45412.

The second circumstance is if a person sells prepaid access, **including closed loop prepaid access**, to funds that exceed $10,000 to any person during any one day without implementing "policies and procedures reasonably adapted to prevent such sales." 76 Fed. Reg. at 45412. (Because the $10,000 threshold applies to any sale of any prepaid access, even if the program is not defined as a prepaid program, it encompasses closed loop cards.) *Id.* Thus, as the prepaid access rule is written currently, even sellers and issuers of closed loop cards would be required to collect customer data, have in place an effective program to prevent money laundering, and make SAR filings if they sell more than $10,000 of closed loop gift cards to any person in any day. 76 Fed. Reg. at 45413-14.

It is highly problematic to require the provider and seller of closed loop gift cards to collect and verify the name, address, date of birth, and identification number for customers, which indicates that FinCEN did not understand the closed loop gift card business model. Many, if not most, issuers of closed loop cards have robust business-to-business (B2B) operations and routinely sell well in excess of $10,000 worth of their cards to another business (a reseller) on any given day. It would be nearly impossible for issuers and even for resellers to collect the required customer identification information. It would be difficult enough to collect such information for sales to customers at retail outlets; it would be nearly impossible for cards sold in bulk (well in excess of $10,000) for use in promotions, for example.

FinCEN appears to acknowledge this difficulty in FAQ 5 when it states that the distribution of prepaid access products to other businesses for further distribution or sale to end users/consumers by those other businesses is **not the type of activity intended to be covered** by the prepaid access rule. This type of activity would not subject a business to the prepaid access rule regardless of whether the activity exceeded $10,000 to one business (*i.e.*, person) in one day. The definition of "seller" is intended to address sales to the end user/consumer of the prepaid access product, not to apply to businesses in the distribution channels that move the prepaid access products to the market. Thus, the FAQs indicate that FinCEN would not subject bulk sales of prepaid access in the B2B context to the various regulatory requirements of its prepaid access rule, including the customer and transaction information recordkeeping and verification obligations.

Businesses may nonetheless be deemed to be "sellers" if they provide non-depository reloads to prepaid access in certain circumstances, however. FAQ 6 states that an entity reloading prepaid access from a non-depository source is a "seller," subject to the provisions of the prepaid access rule, if it (1) reloads funds onto prepaid access that is part of a prepaid program not subject to initial customer verification, or (2) both reloads in excess of $10,000 for any person on any given day, and does not have policies and procedures reasonably adapted to prevent such reloading for any person on any given day. Persons providing non-depository reloads of funds or the value of funds to prepaid access are not sellers if: (i) they reload less than $10,000 of prepaid access that is not part of a prepaid access program covered under the rule for any person on any given day; (ii) they reload less than $10,000 of prepaid access that is part of a prepaid program covered under the rule, but is subject to verification procedures after the initial sale of the prepaid access, for any person on any given day; and (iii) they have policies and procedures reasonably adapted to prevent the reloading of $10,000 for any person on any given day.

Under FAQ 7, a person that qualifies as a "seller of prepaid access" because of the person's reload business (as described in FAQ 6) has the same obligations as any other "seller of prepaid access," including having an anti-money laundering program, SAR filing, and recordkeeping

and verification requirements. Such a seller does not have to obtain customer identification information, however, from customers who have already provided customer identification information with respect to the prepaid access that they are reloading.

POTENTIAL LEGAL ISSUES INVOLVING THE ANTI-MONEY LAUNDERING RULE, GIFT CARDS AND AWARD PROGRAMS

FinCEN's clarification in its FAQs that the distribution of prepaid access products to other businesses for further distribution or resale is not the type of activity intended to be covered by the prepaid access rule is helpful. This clarification eliminates most potential problems for bulk sales of closed loop prepaid access (*e.g.*, merchant cards) in the B2B context. Nonetheless, the anti-money laundering rule could apply to gift cards in certain circumstances.

In order to avoid the anti-money laundering rule, a company must ensure that its own gift cards are truly closed loop, that not more than $2,000 maximum value can be associated with the card on any day, and that cards cannot be redeemed for cash (except as specifically required by law). If a company sells or reloads gift cards from other companies and open loop prepaid cards, it must not sell or reload cards under certain "prepaid programs" if such cards can be used before customer identification and verification. Anyone who sells such cards should confirm with the issuers that the cards cannot be used before customer identification and verification.

A company must not sell any prepaid cards having a combined value over $10,000 to any single person during any one day, and it must also implement policies and procedures reasonably adapted to prevent such sales. The policies and procedures must be based on risk of money laundering and appropriate to the vendor after taking into account its typical customers, location(s), and volume of prepaid access sales.

While the anti-money laundering rule should not have an effect on award programs, incentive companies and their clients should be generally aware of the rule and its potential application in various contexts. Trade associations and merchants continue to work with FinCEN to ensure that the onerous customer information collection and recordkeeping obligations are not imposed on bulk sales for resale (or further distribution) of closed loop prepaid access.

8. AN OUT-OF-STATE SELLER'S OBLIGATION TO COLLECT FOR AND REMIT SALES AND USE TAX TO A STATE

A. OVERVIEW

In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the Supreme Court reaffirmed the rule of *National Bellas Hess, Inc. v. Dep't of Rev.*, 386 U.S. 753 (1967), prohibiting states from requiring an out-of-state seller to collect sales and use taxes on behalf of the purchaser's state of residence, unless the out-of-state seller had a "substantial nexus" with the purchaser's state. As in *Bellas Hess*, the "substantial nexus" requirement is satisfied only if the out-of-state seller maintains some "physical presence" in the consumer's state. Physical presence includes, for example, a plant, an office, salesmen, independent sales representatives, and so forth. *See, e.g., Scripto, Inc. v. Carson*, 362 U.S. 207 (1960); Ill. Ltr. Rul. No. ST 01-0052-GIL (Mar. 2, 2001).

Thus, after *Quill*, the battleground shifted to what range of activity constitutes enough "physical presence" to require the out-of-state seller to collect sales and use tax from the purchaser. After *Quill* and *Bellas Hess*, the requisite threshold of in-state physical presence has been increased from any amount of in-state property or number of people, no matter how small, to something more than the slightest amount of property or number of people. The New York Court of Appeals has held, however, that the physical presence test can be satisfied as long as it is more than "slightest presence." Therefore, a dozen visits over three years by an out-of-state vendor's salesmen to a New York retailer created physical presence that satisfied the substantial nexus test, as did 30-40 visits by an out-of-state software company's representatives to a New York customer over three years to correct persistent or difficult problems. *Orvis Co. v. Tax App. Trib. & Vermont Info. Processing v. Tax App. Trib.*, 86 N.Y.2d 165, 654 N.E.2d 954 (1995), *cert. denied*, 116 S. Ct. 518 (1995). A Louisiana court of appeals followed the reasoning in *Orvis* and *Vermont Information Processing* and held that Dell Inc. had nexus in Louisiana based on agreements with an in-state technical service provider. *See State v. Dell Int'l, Inc.*, 922 So.2d 1257, 1263-66 (La. Ct. App. 2006). These computer support services were made available on Dell's behalf and at its direction, and Dell controlled many key aspects of the services provided. In addition, Dell advertised the support services, and it dispatched the service provider to thousands of service calls. In essence, the relationship between Dell and its service provider resembled an employment relationship instead of an independent contractor relationship. Therefore, Dell had substantial nexus in Louisiana.

A Utah court has also held that repeated trips into the state when coupled with "significant" business activities that were consistent with maintaining a market for the company's sales into the state created substantial nexus. *B.L. Key v. State Tax Comm'n*, 934 P.2d 1164, 1168 (Ut. Ct. App. 1997). Similarly, a Tennessee appellate court has held that when a corporation is physically present in a state between four and thirteen days each year over a three-year period, the substantial nexus test was satisfied. *Cole Bros. Circus, Inc. v. Huddleston*, No. 90-3463-II, WL 190914 (Tenn. Ct. App. 1993). The company's presence consisted of substantial equipment that was hauled on 27 trucks with 209 full-time employees. An Arizona Court of Appeals also concluded that a corporate vendor had nexus on the following facts. The vendor assigned one of its employees who lived in California to service Arizona. That employee spent almost of his efforts servicing customers in southern California. During the seven-year audit period, (i) that employee made one sales call per year (each lasting one or two days) into Arizona, (ii) nonresident personnel spent a total of 80 days in the state training the vendor's customers, and (iii) the vendor completed about 180 transactions with Arizona nursing homes. *Dep't of Rev. v. Care Computer Systems,* 4 P.3d 469 (Ariz. Ct. App. 2000). The court of appeals reversed the ruling of the Board of Tax Appeals, which had concluded that more than just an occasional visit into the state was required to establish nexus. The reasoning of the appeals court is rather specious, but it highlights that courts will go to great lengths to impose a use tax collection obligation on an out-of-state vendor.

On the other hand, the Florida Supreme Court has held that the temporary presence (three days each year) of an out-of-state seller at a Florida trade show did not constitute physical presence in that state under *Quill*. *Dep't of Rev. v. Share Int'l, Inc.*, 676 So.2d 1362 (Fla. 1996), *cert. denied*, 117 S. Ct. 685 (1997). In *Share*, the corporation manufactured and distributed chiropractic supplies and sold them through direct mail. Other than the presence of its president and vice-president as speakers at a national seminar in Florida, the corporation had no physical presence in the state. A retailer that attends trade shows in California will also not be deemed to have physical presence in that state as long as it does not spend more than 15 days in the state in any twelve-month

period and does not derive more than $100,000 in gross receipts in the trade show during the prior year. CAL. REV. & TAX. CODE § 6203(d) (Deering 2013).

Most states that have taken a position on whether attendance at trade shows in the state would constitute physical presence have ruled that it would not. Thus, the New York Department of Taxation and Finance has issued an advisory opinion that a nonresident corporation's sponsorship of three one-day trade shows did not create nexus for corporate income tax purposes. By analogy, attending a trade show for no more than three days a year should also not create nexus for sales tax purposes. This conclusion is supported by the decision of an administrative law judge that attending seminars and conferences in New York generally does not create nexus for sales tax purposes. N.Y. St. Dep't Tax'n & Fin. TSB-A-97(7)C (Mar. 26, 1997). Thus, attending trade shows in New York for three or fewer days each year should not create taxable nexus for sales and use tax purposes in the state. In addition to California Florida, and New York, Illinois, Massachusetts, Nevada, and Virginia have also reached the same conclusion. Except in unusual circumstances, or in states that rely unduly on sales tax revenues, a business that exhibits at trade shows for three or fewer days each year should not have nexus for sales and use tax purposes in the state.

The conclusions reached by these and many other states regarding sales tax nexus and trade shows and conferences are common-sense applications of the U.S. Supreme Court's decisions in *Quill Corp.* and *National Bellas Hess*. All states are not as friendly, however. For example, Texas treats exhibiting at a trade show as establishing nexus for sales and use tax purposes. Texas Sales Tax Publication 96-276 (Oct. 2000) provides that if a company exhibits at a trade show in Texas and later makes sales to residents of Texas, it must collect and remit sales and use tax to the state.

The Kansas Supreme Court has held that 11 visits to Kansas over four years by technicians who assisted in the installation of equipment sold by an out-of-state vendor did not create nexus. Each visit lasted a few hours. *In re Appeal of Intercard, Inc.*, No. 83802 (Kan. Sup. Ct. Dec. 8, 2000). The Florida Department of Revenue has also ruled that an out-of-state software vendor that sent employees to Florida for two days each year did not have taxable nexus. Fla. Technical Assistance Advisement No. 00A-021 (Apr. 25, 2000). Similarly, a direct marketer that no longer had physical presence in the state did not create nexus solely by virtue of mailing catalogs into the state, making telephone calls to residents, and having a Web site accessible by residents. Fla. Technical Assistance Advisement No. 00A-020 (Apr. 25, 2000).

In general, courts have also resisted establishing nexus for one corporation based on the physical presence of a parent, subsidiary, or other related corporation. In these cases, a corporation that has physical presence in a state through its stores conducts a catalog business through a separate subsidiary that lacks physical presence in the state. As long as the affiliate with physical presence does not act in an agency capacity for the catalog affiliate, nexus should not be attributed to the latter corporation. *See SFA Folio Collections, Inc. v. Tracy*, 73 Ohio St. 3d 119, 652 N.E.2d 693 (1995); *SFA Folio Collections, Inc. v. Bannon*, 585 A.2d 666 (Conn. 1991); *Current, Inc. v. State Bd. of Equalization*, 24 Cal. App. 4th 382 (Cal. Ct. App. 1994); *Bloomingdale's By Mail, Ltd. v. Dep't of Rev.*, 567 A.2d 773 (Pa. Commw. Ct. 1989), *aff'd*, 591 A.2d 1047 (Pa. 1991).

Another issue that arises in determining whether a company has nexus for tax purposes is whether the nexus can be created through the activities of unrelated parties. Thus, for example, an Arizona court has held that the state could impose use tax on the taxpayer due to catalogs that were mailed into the state because it also had two stores in-state. The court found implicitly

that the U.S. Postal Service was the taxpayer's agent. *Service Merchandise Co. v. Dep't of Rev.*, 937 P.2d 336 (Ariz. Ct. App. 1996).

Finally, courts in several states have reached different conclusions on similar facts concerning the activities of teachers in connection with the sale of books to students. Thus, the Kansas Supreme Court held that where the taxpayer sent catalogs to teachers in Kansas who then collected and submitted the orders to the taxpayer, the teachers were its agents. Accordingly, nexus was created. (The teachers received bonus merchandise from the taxpayer in exchange for the student purchases.) *Matter of Scholastic Book Clubs, Inc.*, 920 P.2d 947 (Kan. 1996); *Scholastic Book Clubs, Inc. v. State Bd. of Equalization*, 255 Cal. Rptr. 77, 207 Cal. App. 3d 734 (1980). On similar facts, two other courts have held that the teachers were not the agents of the bookseller, and nexus did not exist. *Pledger v. Troll Book Clubs*, 871 S.W.2d 389 (Ark. 1994); *Troll Book Clubs v. Tracy*, No. 92-Z-590 (Ohio Bd. Tax App. Aug. 19, 1994).

In another case, a California court of appeals has held that Borders, Inc. was an agent for its online subsidiary limited liability company, Borders Online, LLC. The court noted that Borders allowed its stores to accept returns and provide refunds or store credits, encouraged its store employees to refer customers to its on-line operation, and receipts at Borders stores sometimes invited customers to "Visit us online at www.Borders.com." The appeals court noted that a document that Borders provided to the Board of Equalization described Borders Online as "an extension of the Borders brand" while stressing the benefits of cross referrals. As such, the court could conclude justifiably that Borders, Inc. created physical presence for its online operation. *See Borders Online, LLC v. State Bd. of Equalization*, 29 Cal. Rptr. 3d 176 (Cal. Ct. App. 2005). In contrast, on facts similar to *Borders Online*, a federal district court held that barnesandnoble.com, LLC did not have to collect and remit Louisiana's sales and use tax. *See St. Tammany Parish Tax Collector v. barnesandnoble.com, LLC*, No. 05-5695 (E.D. La. Mar. 22, 2007). Barnesandnoble.com, LLC ("Online") is an Internet retailer of books, movies, and music through its Web site, "www.barnesandnoble.com." For the five taxable years involved in the case, 2001 through 2005, Online had no employees, tangible property, mailing address, telephone number or any other kind of physical presence in Louisiana. From January 1, 2001 through October 2003, Barnes & Noble, Inc. owned 40 percent of Online. Between October 2003 and May 2004, Barnes & Noble, Inc. owned 80 percent of Online through a wholly owned subsidiary, and thereafter, Barnes & Noble, Inc. owned all of Online through a wholly owned subsidiary. Barnes & Noble, Inc. also owned all of Barnes & Noble Booksellers ("Booksellers"), which owned an operated retail stores throughout the country, including Tammany Parish, Louisiana. Booksellers and Online did not share management, employees, offices, or any other important elements of their business. The tax collector nonetheless argued that the nexus of Booksellers should be attributed to Online because of the following aspects of their business relationship: (1) the companies offered a membership program to customers, and Online derived revenue from the annual fees, (2) Booksellers sold gift cards that could be redeemed with Online and included Online's Web site address, (3) Online received commissions on merchandise ordered at the retail stores of Booksellers but shipped directly to the customer, (4) the two companies advertised on behalf of each other, and (5) the retail stores of Booksellers gave preferential treatment to returns of merchandise that customers purchased from Online. The court considered all of the activities of Online and concluded that it would not attribute the nexus of Booksellers to Online. As a result, Online did not have substantial nexus with Louisiana. The court did not view the membership programs or the sale of gift cards as particularly relevant because neither program produced revenue for Online by virtue of sales

made or orders taken within St. Tammany Parish. The fact that Online may have benefited from the advertising of Booksellers of the gift cards and the membership programs was insufficient to establish nexus. While Online received commissions from the sale of merchandise ordered in stores but shipped directly to the customer (because the item was not in stock), Booksellers had similar arrangements with a host of unrelated wholesalers, including its competitors, as well. The Parish did not introduce any evidence that Booksellers treats Online differently from other third party wholesalers. The court also rejected the argument that the preferential treatment that Booksellers gave to returns of merchandise that customers had purchased from Online created nexus. In so doing, it disagreed with the decision of the California Court of Appeals in *Borders Online, LLC v. State Bd. of Equalization*. The court held that the level of sales support provided by Booksellers to Online fell considerably short of the level of support provided by in-state agents in cases where the courts found the requisite nexus to exist. Alabama, Kansas, Indiana, Louisiana, and Minnesota have also amended their sales tax nexus laws to clarify that the physical presence of an affiliate in the state can create nexus for the out-of-state vendor (i.e., entity isolation does not prevent Internet retailers from being required to collect state sales and use tax). The Multistate Tax Commission has drafted model sales tax legislation aimed at entity isolation.

As a result of *Quill* and *Bellas Hess*, where an incentive company has no physical presence in a state, it should be treated as a direct marketer and would not have to collect the sales or use tax on behalf of that state. A supplier (usually a manufacturer) should not seek to require the incentive company to collect and remit sales or use tax if the latter provides a resale certificate, because the incentive company should have no legal obligation to collect and remit such taxes. If an incentive company does not pay sales tax in various states because it lacks taxable nexus there, however, those states may try to force the supplier to pay sales tax to them. Thus, the dilemma facing a supplier is how to reduce its possible exposure should any state seek to collect from it sales taxes not paid by an incentive firm. The net result is that an incentive company and its suppliers are often at odds when it comes to sales taxes. The incentive company can properly say that it provided a resale certificate to its suppliers and, therefore, the suppliers are not responsible for collecting and paying sales tax. The suppliers can probably sympathize, but they want to reduce their exposure for sales taxes, avoid audits and, possibly, litigation.

Ultimately, the physical presence requirement for nexus may have to give way as sales and use taxes are modernized to become more compatible with the Internet and online sales and use taxes will become part of the reality of e-commerce. Indeed, Justice Kennedy pointed to just such an outcome in his concurring opinion in *Direct Marketing Ass'n v. Brohl*, 135 S. Ct. 1124, 1135 (2015) (Kennedy, J. concurring). He noted in a case involving a Colorado sales and use tax reporting law and the Tax Injunction Act that it is time for the court to reconsider and overturn its decisions in *Quill* and *National Bellas Hess*. While *National Bellas Hess* may not necessarily have been wrongly decided in 1967, the Supreme Court was analyzing commerce clause cases differently in 1992 when it decided *Quill*. The court nonetheless reaffirmed *National Bellas Hess* in 1992 solely because it was existing precedent.

On a more practical level, Justice Kennedy noted that the national marketplace had changed considerably since the court decided *Quill* in 1992, with the Internet and electronic commerce as the main drivers of this change. For example, mail order sales were estimated to be $180 million in 1992, but they had reached about $3.16 trillion in 2008. He states that "Given these changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of

the Court's holding in *Quill*. A case questionable even when decided, *Quill* now harms States to a degree far greater than could have been anticipated earlier."

Due to the increasing importance of electronic commerce, there is a strong argument that a retailer conducting extensive business in a state has sufficient nexus with that state to be required to collect and remit that state's sales and use tax, even if the retailer conducts that business remotely only (i.e., without physical presence). Therefore, Justice Kennedy concluded that the holding in *Quill* should be left in place only if there is a compelling showing that its rationale is still correct. After reading Justice Kennedy's concurrence, it seems likely that, in the fairly near future, out-of-state sellers will be required to collect and remit state sales and use tax everywhere they do business regardless whether they have any physical presence.

So far, Congress has not required all retailers to collect and remit sales and use taxes by enacting federal legislation, and given the legislative climate, it may not do so. As a result, it may fall to the Supreme Court to impose that requirement as soon as the opportunity presents itself. In that regard, Alabama, South Dakota, and Tennessee have taken important first steps in that process by amending their state sales tax laws to require out-of-state vendors without physical presence to collect their use tax in direct violation of *Quill*. Alabama adopted a new sales tax regulation that requires large out-of-state sellers to collect and remit its state sales and use tax effective January 1, 2016. For these purposes, a large retailer is defined as one with retail sales over $250,000 per year. Likewise, South Dakota enacted a law that requires out-of-state retailers with "economic presence" in the state, *i.e.*, those with retail sales of at least $100,000 or with at least 200 transactions annually with South Dakota residents, to collect and remit sales and use taxes effective May 1, 2016. On October 3, 2016, Tennessee adopted a new sales tax rule that requires large out-of-state sellers to register with the state by March 1, 2017 and to collect and remit state sales and use tax effective on July 1, 2017. For these purposes, a large retailer is defined as one with retail sales over $500,000 per year. Like Alabama, South Dakota, and Tennessee, several other states are considering enacting legislation that would directly challenge *Quill*.

POTENTIAL LEGAL ISSUES INVOLVING SALES AND USE TAXES AND NON-CASH AWARD PROGRAMS

An out-of-state seller who solicits sales by mail order or electronic means does not have to collect sales and use taxes on behalf of the purchaser's state of residence, unless the out-of-state seller had a "substantial nexus" with the purchaser's state. For these purposes, "substantial nexus" is satisfied only if the out-of-state seller maintains some "physical presence" in the consumer's state. Sales outlets, such as stores, offices, sales representatives (including independent sales agents), any significant property, and equipment are some examples of physical presence. Likewise, if a vendor makes more than a few visits to a customer, sends employees to train customers how to use a product, or sends employees to service a product, it may be creating physical presence in a state.

Sales and use tax reporting and collection has the potential to create a stumbling block in any award program involving an incentive company or a fulfillment center. Many companies that use award programs have physical presence in most, if not all, states, whereas, incentive companies are more likely to have physical presence in a few states at most. Thus, when an incentive company ships merchandise to an employee redeeming points under an award program, it would probably not be required to collect sales or use taxes either due to lack of physical presence in the ship to state. (There is some dispute whether the state where employer is located or where the

employee resides would be entitled to impose its sales or use tax. In many cases the state where the employer and employee are located is the same.)

Because state tax departments would face a difficult legal task in requiring the incentive company to collect and remit tax, they often take the position that the employer is the end user and impose the sales or use tax collection obligation on it. Physical presence presents no hurdle in that context, and the employer would easily have the resources to pay the sales or use tax. Although sales and use tax issues will not prevent any employer from using an award program, it is important for the incentive company and the employer/client to identify this issue in advance and ensure that they reach an agreement in advance with respect to sales and use tax collection and payment.