Do the Benefits of Being in The Cloud Outweigh the Risks?

By Daniel B. Garrie and Anthony I. Giacobbe Jr.

A company that migrates its document management system to a cloud computing solution can save money and realize other substantial benefits, but substantial risks also are associated with migrating to a cloud. Before making a switch, such benefits must be measured against the potential costs and risks.

Migrating systems, especially to a cloud, is not a trivial task. The steps necessary to making this transition include identifying the current data environment, identifying data formats, reviewing security controls for data, and verifying that the cloud can support access needs and training. Companies that successfully migrate to the cloud achieve major benefits by utilizing cloud resources. They can better manage the technology lifecycle, gain the ability to scale information technology (IT) infrastructure capacity to meet increased demand, and lower the time spent waiting for IT resources. The cloud environment provides companies greater business agility in a changing and uncertain economy by allowing companies to rapidly expand or contract IT capabilities. The cloud also enables companies to build and grow their businesses rather than maintain core IT infrastructure — paying only for what it consumes — thus freeing it to focus on its primary business. Collectively these benefits provide a competitive advantage for labor costs, flexibility, and efficiency.

LAST IN A THREE-PART SERIES

This continues part two, which appeared on Sept. 9.

While these business benefits are certainly meaningful, legal and business costs and risks also exist, some of which are discussed below.

Cost of the due diligence process: There are costs to exploring the benefits of the cloud.Select a cloud vendor after considering the terms of implementation, and negotiate the terms of the cloud contract.

Cost of implementation/customization: There are costs to implementing the cloud such as training costs, maintenance costs and troubleshooting. All of these entail a substantial initial investment and a much lower ongoing cost. Even though the cloud vendor may be responsible for maintaining the data and fixing problems, the company will still incur some costs. The company cannot, and should not, expect that it can simply tell the cloud vendor to "handle it" and that the problem will then go away.

Cost of private v. public cloud: In a private cloud, the cloud infrastructure is operated solely for an organization, may be managed by the organization or a third party, and may exist on premises or off premises. A public cloud is defined as a cloud where the infrastructure is made available to the general public or a large industry group and is owned by an organization selling cloud services. It is imperative that counsel recognize that public clouds likely have multiple users of the service and that additional care must be taken to ensure that its data is not being exposed to other users such as third parties.

The risks of cloud computing: Though difficult to quantify, the risks involving the cloud data storage are very real. For example, there is the risk of loss or damage to the data. Provisions should of course be made to deal with such problems, but there can be a business cost to any interruption in the normal flow and use of data. Litigation risks are also present. Cloud computing could lead to increased risk of litigation over certain types of data, such as a patent litigation. Of course, the costs of any litigation will include electronic discovery costs, and the company must consider whether these costs will increase as a result of the cloud and should consider whether any increased costs could potentially offset or mitigate the benefits of using the cloud.

For better or worse, the task of evaluating these costs and risks falls primarily upon in-house counsel or their outside counsel. Counsel must review and negotiate the terms of the cloud vendor agreement and account for the various legal issues and other problems that can arise. Counsel should identify how data will be collected and preserved before that data is put on the cloud. A good practice point is to record the results of the due diligence in a data map or other litigation readiness tool and store that along with the contract. Should litigation later arise, the company will be prepared. This may also be useful in the event there is subsequent litigation over the intention of the arrangement.

The business units must be engaged in the entire process as well. Their most important concern should be the handling and treatment of data — how it will be stored, accessed and used. But they will also need to consider the costs. One key point often overlooked is that every cloud computing solution is unique; there is no silver bullet appropriate for all systems in a company. In a large organization, different business units may have very different needs and issues (as well as cost analyses) and store information in different ways. Consequently, each piece will require thoughtful analysis. One possible way to divide information is to segregate information by type. One can treat e-mails differently than other data. Or, if a company uses sales data, production data, and inventory data, it may make sense to store these in unique cloud systems in order to maximum storage and usage efficiency. Thus, depending on the company, the process of implementing cloud computing may involve several different approaches.

In short, clouds can provide significant competitive advantages in use, storage and efficiency of data. But these advantages will only be realized if they outweigh the costs and risks associated with the cloud. Careful attention to these risks at the outset — before implementation of the cloud — is the key to its successful use.

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Zero Estate Tax Planning: Many Roads to Heaven

By Bruce Givner and Owen Kaye

As calendar 2010 winds to a close, people are beginning to think about Jan. 1, 2011. On that date, the 2001 version of the federal estate tax returns. What does that mean? A 55 percent estate tax and a $1 million exclusion. That is a big change both from 2010's zero percent estate tax rate and unlimited exclusion and from 2009's 45 percent estate tax rate and $3.5 million exclusion. Many jokes have been made about the "luck" of the families of billionaires who died in 2010: Mary Cargill died in February. She was worth $1.6 billion and made her money the old-fashioned way (she married into wealth). Dan Duncan died in April. He was a Texas pipeline tycoon worth $9 billion and the 74th wealthiest person in the world. Walter Shorenstein died in June. He was San Francisco's largest landlord. And George Steinbrenner died in July. He owned the New York Yankees.

There are ways to attain a zero estate tax without dying before Jan. 1, 2011. The approach long favored by many was to have a will that reads "Being of sound mind, I spent it all." A client last week requested that when he is "placed in the box, the check to the mortician bounces." This client was worth $250 million before significant estate tax planning resulted in moving $100 million to irrevocable trusts for his children. His situation illustrates the problem with the "I spent it all" approach. How do you program your spending so that the last dollar disappears with your last breath?

One approach is through a "withdrawal" calculation. Assume you are 70 years old and worth $5 million. You have a 17-year life expectancy. Were you to earn 2 percent after tax and consume your assets in equal annual installments, you would spend $380,000 per year. At your death at the end of the 17th year you would have zero dollars left. What if you die prematurely? There will be money left, which is not your goal. What if you live longer? You will be out of money, which will put you on welfare, which is also not your goal.

A well-respected structure can help you achieve the right result: a part-gift, part-private annuity. You would give $500,000 of your $5 million to your children, and sell them the rest for an annuity. The payments would be the same $380,000 as in the withdrawal example. The advantage over the withdrawal format, however, is that if you die prematurely, nothing is included in your taxable estate (the check bounces); and if you live longer, the children must continue paying until you die (you need not go on welfare).

There is another approach to a zero estate tax that leaves you with all of your assets until you die, but one that few people pursue. You leave 100 percent of your assets to charity in your will or trust. You buy a life insurance policy for what you wish your children to receive. Have the policy owned by an irrevocable trust so that the proceeds will not be included in your taxable estate. Depending upon your age and the policy's face amount, payment of the premiums may not constitute "taxable" gifts. This is a terrific approach because it is so simple, and a terrific result, because it is so flexible. However, most people do not like life insurance. (That is a shame, since life insurance is an income tax shelter, and is easy to transfer free of gift and estate tax.)

Conscientious, consistent gifting over time can eliminate estate tax. Use of the annual gift tax exclusion (currently $13,000, but increased by a cost of living adjustment) plus the valuation discounts for giving an interest in a family entity can rapidly reduce the value of even a sizeable estate. Assume you have $10 million of investment real estate. You transfer it to a family limited partnership. A business appraiser opines that the discounts for lack of marketability and lack of control applicable to limited partnership interests are 40 percent. You and your spouse have three children, each of whom has two children. You set up an heirs trust. Using some well-known and respected case law, you can use 24 annual gift exclusions per year (three children plus three in-laws plus six grandchildren multiplied by two donors). That means that the two of you can transfer $312,000 of value per year. The 40 percent valuation discount means that that reflects $520,000 of underlying asset value per year. Assuming no changes in value or discounts, in less than 20 years you can transfer 100 percent of the value of the family partnership. The transfer can happen more rapidly by using your lifetime gift exclusion ($1,000,000 in 2009, which might also be the number in 2011); and sophisticated gifting strategies like private annuities and grantor retained annuity trusts.

There is an attractive approach that does not require any gifts during your lifetime: a "testamentary charitable lead annuity trust" (T-CLAT). This could be viewed as the lazy person's approach to attaining a zero estate tax result. However, people who have engaged in sophisticated lifetime planning but wish to backup that planning commonly use it. A T-CLAT is a trust that comes into existence upon your death. It is funded with the assets remaining in your estate. Those assets generate an annuity, which is paid to a charity which you (or your executor or trustee) select. At the end of a selected term of years, the annuity stops, the T-CLAT terminates and the assets are distributed to your heirs. The higher the annuity and the longer it is paid to charity, the higher the charitable deduction. Assume that upon your death the assets are distributed to a T-CLAT that pays charity an annuity equal to 7.782 percent of the assets' fair market value each year for 15 years. The charitable deduction would be 99.993 percent.

There are many ways to get to a zero estate tax result. Dying in 2010 is only one such approach, and hardly the most attractive one.

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