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International Litigation In America – Discovery

When the Defendant files an answer to the Plaintiff's complaint, many courts will schedule a hearing to set dates for discovery, arbitration, mediation, or trial. These dates may be months or years after the case is filed. Prior to trial, each party must gather the evidence to prove its case. Discovery is a process by which the attorneys discover what evidence exists to support or oppose the law suit's claims. Discovery is engaged in by the attorneys for the parties and rarely involves the Judge. In Germany, a case is developed through each attorney writing letters to the Judge which explain the evidence and attach documents. In the United States, in most courts, the trial Judge does not even know whether information is being gathered. The attorneys are responsible for gathering all the evidence and if, at trial, a piece of evidence is lacking, the Judge will rule against the party who can not present the necessary evidence.

Discovery takes several forms. The attorney for one party may send written questions, (interrogatories) to the other party. A party may request documents from the other party or may request that a fact be admitted or that certain documents are genuine. Full and compete answers under oath, along with documents, must be provide. The most important form of discovery is the deposition. A deposition is the taking of testimony under oath of a witness or party before trial and documents are usually produced. The deposition is used at trial to attack testimony of a party or witness, to preserve testimony and for other purposes. The attorneys meet with the witness and asks very detailed questions. For example, a corporate executive will be asked about his
education and background, about the details of his job, about his relationships with other workers, and about any damages that the Plaintiff in the case is alleging. Most participants in litigation require the help of an experienced attorney who visits the client, helps answer the questions, assemble the documents and prepare for the deposition.

Discovery of data on computers, cell phones, fax machines and other electronic devises is the hot topic in the legal world today. Archival, email, stored, deleted and meta data can all be the subject of a discovery request.

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Important Considerations In Corporate Governance

In this article I will highlight three important aspects of international agreements relating to transactions with the United States.

1. No written contract necessary

The most important point is that in the U.S. no written agreement or contract is necessary to bind the parties. Most international trade transactions occur without the benefit of written agreements. A valid and enforceable contract may be established from the course of actions and dealing between the parties, by establishing contractual intent from the correspondence and communications of the parties, or even by evidence of an oral agreement. When these circumstances establish the intent of the parties to bind each other, courts in the United States will usually hold that a contract binding the parties has been established.

Therefore, when a party feels that the entity with which it is doing business has violated an agreement, that party should not hesitate to obtain relief from the courts. No written contract is necessary.

2. Payment terms and guarantees of payment

Nevertheless, written contracts are greatly preferred. The price to be paid and the manner of payment should always be in writing. Since most disputes arise out of failure of payment, the contract should also provide, if possible, for payment by letter of credit or should be guaranteed and secured by tangible property. In the U.S., such guarantees are easily obtained by the signing of a UCC-1 form, which is commonly used in domestic transactions. It is also important that the agreement state in writing that failure to pay any payment on time constitutes a breach of contract, and results in the entire contract amount being due.

3. Dispute Resolution

The contract should set out the forum and location of dispute resolution, whether in court, arbitration, or otherwise, and the law to be applied. New York law has a provision permitting the designation of New York courts as the forum to try disputes even if the transaction had nothing to do with New York. New York law also has a provision permitting litigation in any foreign currency, not just dollars. If you are the seller, you will also want a provision prohibiting jury trials, and providing for the payment of legal fees to the winning party. In general, binding arbitration is usually less expensive and quicker than litigation. Arbitral awards obtained in a foreign country are also usually more easily enforceable in U.S. courts than foreign court judgments. Before designating the forum, the selling party should ensure that any judgment it may obtain in a foreign jurisdiction will be enforceable in the jurisdiction where money to satisfy the judgment may be found. If not, the selling party will have to try the case all over again.

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The Next Frontier: Greentech Mergers and Acquisitions

Mergers and acquisitions in the nascent U.S. greentech industry still pale in number and size compared to acquisitions in more established industries. Most transactions in this industry involve financing, with substantial funding coming from public sources. As public money is expected to dry out, observers wonder whether venture capitalists will step in, or whether the industry will be forced to look elsewhere to finance its growth.

Because of their global leadership and their active role in international greentech m&a, German companies with greentech expertise are logical partners for emerging U.S. greentech companies. The renewable energy sector and the fast growing energy efficiency markets may look particularly attractive to German companies with expertise in these fields. However, the risk that green technology could be the next bubble is very real. Therefore, the lessons from previous technology booms should be remembered, and the particular challenges faced in this industry should not be underestimated in evaluating and structuring an investment in green technology.

For the foreseeable future, profitability of many greentech companies, particularly in renewable energy, will depend on government incentives. The discrepancy between ambitious political goals and empty federal and state coffers could weigh heavily on the value of these companies and creates challenges in drafting earn-out, incentive, and other provisions in acquisition or investment agreements.

Environmental and other laws, the regulation of energy markets, evolving standards, and the unavailability of contracts, grants or incentives after a change of control could potentially undermine the viability of an acquisition. The capital structures of venture-backed greentech companies provide additional challenges. Not only can existing investors potentially control the terms and success of an investment, they can also influence the negotiation, structure and pricing of an outright acquisition. Finally, the strength of the target's intellectual property rights and know-how must be carefully evaluated.

Strategic investors from Germany should take a long-term view of an investment in the U.S. greentech market and be certain they have the financial strength to overcome the daunting risks of such an investment. Solid preparation, carefully negotiated agreements, and a thorough understanding of the legal issues faced in this industry are prerequisites for mitigating risks and unlocking the potential of these still underdeveloped markets in the United States.

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Veritas Software Corporation vs. Commissioner Relevance of Cost Sharing Arrangements (CSA) in the U.S.

On Dec 10, 2009 the US Tax Court released an important decision in favour of the taxpayer. Veritas had a CSA in place, which are important for multinational companies that are pooling intellectual property and are sharing in the cost. The matter of the IRS's claim was that pre-existing intangibles contributed by Veritas Inc., a US corporation, to an Irish subsidiary (Veritas Ireland) had a value of more than $ 1.5 billion, nearly ten times the value determined by the taxpayer. The court described in its decision that the IRS's valuation of these pre-existing intangibles was "arbitrary, capricious and unreasonable". The potential impact that the decision will have on current audits, the new temporary CSA regulations and more generally on transfers of intangibles, is material.

The decision has broad importance due to theories used by the IRS. The court goes beyond buy-in theories and especially the broadening of the definition of "intangible property" for sec. 482 and 367 (d) which is part of the Obama administration's proposal to include "workforce in place", "goodwill" and "going concern value". That new definition is going closer to methods applicable to a "sale of business" or a market capitalisation. Fortunately Veritas was well prepared compliant with former provisions. The court decided that the taxpayer should not be prescient.

It is very fruitful to see the disputed matters relevant for evaluation which were refused by court. The IRS valued the transferred intangibles in the aggregate including synergies with an extend of greater value than each asset standing alone. The IRS claimed a transfer of goodwill and other non product items e.g. "distribution channels", "customer lists" and "customer base", access to research and development team" and "access to marketing team". The court also found that the IRS used the wrong beta-factor and the wrong equity risk premium which led the IRS to use an incorrect discount rate. Finally the court found that the CUT method used by the taxpayer was the best method. Veritas had licensed the same intangibles to various unrelated parties in a variety of contexts and used these licenses in a basis for a CUT for the buy – in transaction.

On Jan 5th 2009, the US Department of Treasury and the IRS issued an amended Section 482 regarding cost sharing agreements (CSA 1.482-7T). The new regulations are important as they discuss new methods of determining appropriate distribution of taxable profits and documentation requirements. The new

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Veritas Software Corporation vs. Commissioner Relevance of Cost Sharing Arrangements (CSA) in the U.S.

amended provisions focus on determining a commensurate remuneration of Cost-Sharing-Transactions (CST) and Platform Contributions Transactions (PCT; former buy-in payments).

The Veritas decision and related transfer pricing matters for any multinational company may be discussed in more detail at:

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Global M&A Markets

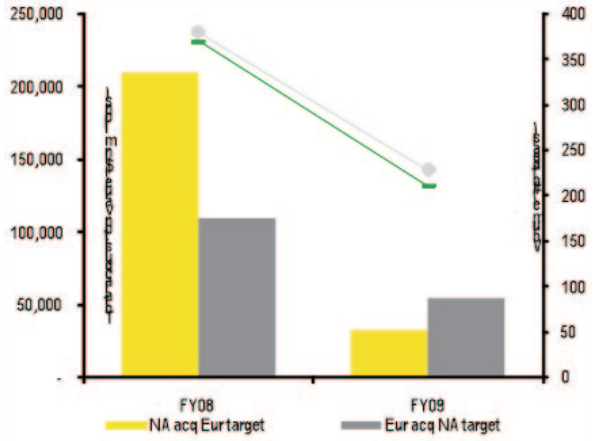
After having seen 2009 second half recovery optimism for 2010 appears warranted. With overall global deal value and volume ending the year 27% down on the previous year, 2009 was not a good year for global M&A.

The last quarter of 2009 was the best quarter in value terms since the third quarter of 2008. With 2,523 announced deals valued at US$626.8bn, the quarter saw an increase of 35% over the same period in 2008; and of some 90% compared to the previous quarter.

Expectations for 2010

Though there is still uncertainty in the markets, there are signs that the momentum will carry into 2010. A resurgence in financial sponsor activity, corporate buyers sitting on record levels of cash, and a thawing credit market, could signal a good year for M&A deal makers.

Transatlantic Deals



In 2009, the overall value and volume of transatlantic deals (ie European bidder acquiring a North American target or a North American bidder acquiring a European target) has declined more significantly than the overall M&A market. Compared to 2008, transatlantic deals decreased by 44% by volume and 72% in value. This indicates a decrease of risk appetite of corporations to acquire outside their immediate home markets as well as a decrease in deal size. Both of these developments appear to be directly connected to the freezing of the debt markets, in which bankable deals would be rather small and rather domestic. Also, corporations were mostly concerned about their credit ratings.

Analyzing the direction of the transatlantic deals it is interesting to note that in 2009 the relative importance of deals in which a North American bidder acquires a European target company has significantly increased: While in 2008 the number of deals in either direction were about equally sized, in 2009North American bidders acquiring European targets outweighed European bidders relative to North American targets by about 10%. However, the average deal size (by value) changed differently depending on the origin of the bidding company: The average North American bid European acquisition was valued at US$552m in 2008 while it amounted to a mere US$142m in 2009. The European

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Global M&A Markets

bid North American deals by contrast did not change as much in average value – from US$297m to US$260m. This development reflects some outliers in US bid European deals in 2008. But it now appears that North American headquartered corporations tend to add smaller acquisitions to their portfolio, rather incrementally investing into niches or individual add-on acquisitions. The European bid deals by contrast remained rather steady at approx. US$275m, indicating that these deals are of a more strategic nature, securing their footprint in the US, Canada and Mexico.

United States acquirer, German target

The above analysis is also representative of the development of deals where a US acquirer takes over a German target company – approx. US$8,020m deals were announced in 2008 while deal volume fell to approx US$1,800m in 2009, or by 77%.

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M&A: Earnouts – A tool to bridge valuation gaps in uncertain times

Earnouts are making a comeback. Under the typical earnout a seller would receive additional consideration based on achieving certain performance targets. While recent changes to the accounting rules (FAS 141R) made earn-outs less attractive because they require companies to value any contingent purchase price at the outset, earnouts still offer an effective tool to bridge valuation gaps in uncertain times. They are particularly useful for the purchase or sale of development stage businesses, new products/technology without track record, dependence of a business on few customers, businesses in the midst of a turnaround, uncertainty over the chances of achieving synergies in combining two businesses and other situations with uncertain outlook. There are risks to both parties but a carefully structured earnout will minimize them.

Typically each party will have to give up some degree of control which can delay integration efforts. However, if properly structured they tend to mitigate the concerns of a buyer who does not want to over pay and a seller who does not want to sell on the cheap. What needs to be considered? Finding the right metric to determine the value of the earnout and setting the right incentives are key considerations. For example an earnout can be based on EBITDA, EBIT, operating income, gross profits, sales, net sales, cash flow or cost savings from synergies. Defining the right accounting rules is equally important. Simply providing for GAAP and IFRS may not be sufficient. Important and unexpected changes may result from different inventory methodologies, depreciation schedules, acquisition debt, transaction expenses and extraordinary items in the consolidated financials. In order to avoid an adverse impact on the earnout from different accounting rules two sets of books may be required, one to keep track of the earnout and the other to present consolidated financial statements. In longer earnouts the parties need to focus on events that could cut the period short, such as sale of the target by the buyer, sale of the buyer, IPO, recapitalization etc..

These events can either accelerate the payment of the earnout of let the seller participate in sale proceeds. Lastly a word of caution: Earnouts can result in litigation. A recent court decision in Massachusetts made that risk abundantly clear. In Sonoran Scanners Inc. v. PerkinElmer Inc., the court decided that the buyer had an “implicit” obligation to exert reasonable efforts to develop and promote the seller’s products. The agreement was clear in setting the right metric for the earnout. The deal was unsuccessful and the earnout was not earned. But the agreement did not specifically exclude that “implied” obligation and the buyer was required to pay the full earnout. The decision serves as a reminder for deal professional to carefully consider all aspects of an earnout.

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First Experiences with the New Rules for Private Limited Companies in Germany

On November 1, 2008, the reform of the Law governing Private Limited Companies ("PrLC"; in German: "GmbH") came into force, introducing for the first time a Private Limited Company which can be established with just 1,00 share capital. This kind of Private Limited Company is called "Unternehmergesellschaft (haftungs-beschränkt)", in English, a "limited liability entrepreneurial company". The company's name has to contain the acronym "UG". In the first year of the existence of the new law, more than 22.000 of these companies have been incorporated, many more than expected when it came into force.

What are the characteristics and which are the strong and weak points of this new legal entity ?

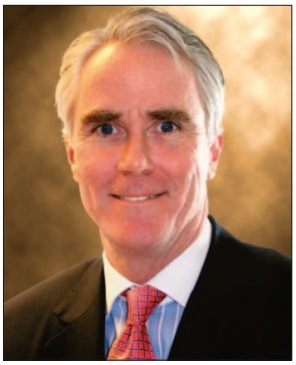
The new law adjusts the PrLC to the needs of start-ups which do not have or need much money at the beginning (e.g., in the service sector) and allows the formation of a company without a certain minimum nominal share capital. Thus, the founding Shareholders do not have to raise the minimum share capital of □ 25.000,00 which otherwise is mandatory for a Private Limited Company (GmbH). At the beginning, it may, however, not completely distribute its earnings and thereby accumulate the minimum share capital of 25.000,00 EUR of a regular GmbH little by little.

The reform is not only supposed to make the PrLC more attractive at the time of its formation but also to raise its profile in the marketplace as a good way of structuring a business. Now, it is possible to choose an administrative domicile (where the management is conducted) in a foreign country (which was not allowed in the past). The administrative domicile need no longer be the same as the statutory domicile of the company.

There are other features of the new law simplifying the life of existing PrLCs. Examples: the possibility to acquire shares in good faith; the acceptance of cash pooling, a common financial mechanism among international corporate groups; and a simplification on the rules of Shareholder capital substitution. PrLC have to file a German business address with the Commercial Registry. Also, Shareholders are required to file for bankruptcy in case of over-indebtedness or insolvency if the Managing Director cannot be located. Additionally, the grounds for incapacity for a Managing Director to serve have been expanded. Individuals who violate core provisions of white-collar crime laws are ineligible to serve as Managing Directors.

Businessmen, however, who deal with a PrLC without a minimum share capital ("Unternehmergesellschaft, haftungsbeschränkt", or "UG") should not give these entities any credit without asking for an additional security, for example, a personal guarantee of the shareholder because this kind of entity typically lacks any solid capital basis, at least in the first couple of years of its existence.

The "Green House" Movement in the U.S. and Germany



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As General Counsel and Commissioner of the Department of Environmental Conservation of the State of New York under Governor George E. Pataki, I was very conscious of the enormous impact buildings have on the ways our cities and towns contribute to climate change. In addition to the energy consumed by large AC and heating systems, the environmental impact of the building cycle has led to legislation at the international, national, and local levels to improve energy efficiency and promote environmentally friendly design in commercial buildings. "Green houses," so to speak.

Recognizing that the built environment is responsible for 40% of global CO2 emissions, the Sustainable Building and Climate Initiative of the United Nations Environment Program seeks to promote internationally recognized sustainable building and construction practices. The intent is to encourage all stakeholders to adopt a life cycle cost approach to measuring operations of building materials.

Domestically, the Energy Policy Act of 2005 included tax incentives to improve the energy efficiency of large commercial buildings. Supported by the National Electric Manufacturers Association and the Natural Resources Defense Council, the "Commercial Building Tax Deduction" creates a deduction for expenses incurred by building owners investing in various forms of energy efficiency.

The New York City Council recently passed legislation providing the first major update to its building codes in close to 40 years. The new codes require building owners to pay for energy audits which address steps to reduce overall energy consumption. In New York City, where buildings account for 80% of CO2 emissions, the hope is that measuring energy consumption and proposing solutions will be the first steps towards managing building energy loads more efficiently.

In Germany, two legal regimes are of relevance. In October of 2009, the new Energy Saving Regulation (Energieeinsparverordnung) further tightened the energy efficiency standards previously required by the 2007 regulation for new or comprehensively refurbished buildings. Overall energy demand is to be further reduced by an average of 30% and energy efficiency is to be increased by an average of 15%. A 2012 regulation, expected to tighten the required energy efficiency standards by another 30%, is already being discussed.

The 2009 Renewable Energies Heat Act (Erneuerbare-Energien-Wärmegesetz), sets forth that when developing a new building or refurbishing an existing one, the owner has to ensure that a certain percentage of the needed heat energy is obtained from renewable energy sources or from clearly defined other climate friendly sources.

Given the attention on both sides of the Atlantic, the built environment has an opportunity to substantially reduce its energy consumption and improve environmental quality.

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Upcoming Decrease of Feed-in Tariffs for New PV-Installations in Germany with Effect to 1 July 2010

The dynamic increase of photovoltaics in Germany is a success story. However, project developers, fund initiators and investors who are thinking of realising or financing photovoltaic installations in Germany should act quickly in order to benefit from the current – high – feed-in tariffs.

By the end of 2009, installations with a total capacity of around 9,000 MW had already been installed in Germany. In 2008 and 2009 alone, the installed ca-pacity of PV-facilities in Germany doubled. However, the new Federal Gov-ernment intends to lower the feed-in tariffs for electricity from photovoltaics by 11 %, 15 % and even 16 % in the short term.

The basis for the hitherto successful increase of photovoltaics in Germany is the feed-in tariff guaranteed by the Renewable Energy Sources Act (EEG), which guarantees feed-in remuneration way above the market price for a period of 20 years. For new installations, this reduces each year by a certain percentage in order to take into consideration the continued progress with technical develop-ment and savings potential. Following this regular reduction with effect to 1 January 2010, the feed-in tariff for new installations on open spaces is currently 28.43 Eurocents per Kilowatt hour and for roof installations a maximum of 39.14 Eurocents per Kilowatt hour.

However, the Federal Government takes the view that photovoltaics have been over-subsidised. The reasons for this are the worldwide price drop and the over-supply of solar modules first ascertained in 2009. On 3 March 2010, the Federal Government therefore announced a new framework for future photovoltaics re-muneration.

In addition to other alterations, the over-subsidisation is in particular intended to be compensated by a one-off reduction of the feed-in tariffs. With effect to 1 July 2010, the remuneration rates for new roof installations are reduced by a further 16 % in addition to the regular reduction. For new installations on open spaces, a reduction by 11 % will take place with effect to 1 July 2010, if the installations are located on so-called conversion spaces or on already sealed areas. For all other installations on open spaces the feed-in tariffs are reduced by 15 %. Due to the longer planning periods, however, the one-off reduction for installations on open spaces shall not apply to installations which are commissioned before 1 January 2011 and which are located within the area of a zoning plan enacted by the end of 2009.

The new framework now needs to be passed by the lower house of parliament and therefore might still be subject to changes.

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International IP - Avoiding Stumbling Blocks

The world of Intellectual Property is at least as much divers as the world in general. To protect their Intellectual Property, applicants should rely upon the expertise of Patent Attorneys and their long-lasting network of worldwide IP-experts.

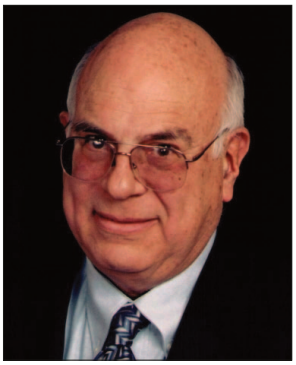
To elucidate the sometimes crucial differences between Intellectual Property laws of different countries, the following article focuses on International Patent and Design law and problems arising from Employees inventions.

Relying on local practice might cut off different ways of obtaining protection in other countries right from the start. For an example, filing a valid US patent application after having used the one year novelty grace period excludes the possibilities of obtaining patent protection abroad, because a novelty grace period is unknown to almost all of the other countries in the world. If an applicant has avoided such mistakes, he might use the path of the Patent Cooperation Treaty (PCT) to postpone the decision, for which countries a patent is actually sought after. The PCT path allows a single patent application in a single language at a single office to be valid in 142 countries worldwide. During PCT, the application is checked formally and the applicant receives an official state of the art search together with a reasoned statement to novelty and inventive step. After 30 or 31 months, the applicant has to specify the countries to proceed in with his application. An applicant not in need of additional time and able to spend translation and representation costs earlier might directly file a regional patent application like an European Patent Application or might decide to file single national applications like a German or a Chinese application. By doing so he will save the PCT expenses and if he keeps in mind to amend the set of claims to an often allowed multi-dependency he will reduce his costs sometimes enormously.

In the field of designs, an applicant will have to keep in mind that in many countries protection is granted to what is depicted and that a more detailed view in the application gives a better protection. This is completely contrary to US practice according to which the scope of protection is broader the fewer details are shown. To get protection abroad, an applicant might use the European Community Design or the Hague path of international deposition or he might file single national applications, like German applications.

US applicants will have to keep in mind that employees will have the right of additional remuneration in Germany for their inventions and that certain legal steps are needed to be taken to transfer the right from the inventor to his employer. Ignoring to do so might cause severe problems.

In summary, it is vital to know IP even prior filing an application.



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Licensing, Selling or Buying IP in the U.S.?

Intellectual Property (IP) transactions in the United States are like any other type of transactions: local contract law applies. There are some important differences, however.

Parenthetically, it is generally wise to specify which state or country's law is to govern the interpretation and construction of the contract so that the choice of law, and the law itself, are clear. The law of any state or country that has some significant contact with any one of the parties to the transaction may be chosen. Normally the parties select their own jurisdiction's body of law, particularly when the law of this jurisdiction has developed thoroughly over time through much commercial litigation, as is the case in New York or New Jersey. When the parties cannot agree on a choice of law – as may be the case between parties in Germany and U.S. – they often turn to International Arbitration.

What makes IP transactions unique is the interplay between local contract law and federal law. IP rights in the U.S., whether patent, trademark or copyright, are normally based on federal law. State trademark, copyright and trade secret laws do exist, but where the federal law has been invoked, as is usually the case, such federal law takes precedence over the state law.

When federally granted IP rights are conveyed, the assignment can and should be recorded in either the U.S. Patent and Trademark Office (for patent and trademark registration applications, whether issued or not) or in the U.S. Copyright Office (for copyright registration applications, whether issued or not). To retain confidentially, the entire contract is usually not recorded. Only the assignment document is recorded and thereby made publicly available. Such recording gives notification of the transaction to third parties and thereby avoids the possibility that a later party can obtain prior rights to the same IP as a "bone fide purchaser for value."

Another unique aspect of IP transactions is the possibility of licensing – either exclusively or non-exclusively – less than all of the rights. A copyright, for example, consists of a "bundle of rights" each of which is severable from the bundle and separately licensable. Similarly, patents may be licensed for a specific territory and/or for a specific "field of use." Trademarks are licensable for specific products and/or services and for specific times, and trade secrets may be licensed with strict limitations and controls.

IP transactions – the sale or licensing of IP – is an extremely interesting but complex area of the law. While many strategies are possible under the law, many are not, so before proceeding to draft an agreement, it is best to discuss your objectives with an experienced IP lawyer.

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E Treaty Visas: a Useful Tool for U.S. Subsidiaries of European Companies

Many European companies who initiate operations in the United States by either forming a subsidiary or acquiring an existing business are often faced with a challenge when looking to transfer employees to their U.S.-based subsidiaries. They must navigate through U.S. immigration laws pertaining to the employment of foreign employees and their eligibility for a work visa.

In this context, bilateral treaties of commerce and navigation were signed between the U.S. and several countries, such as Germany. These treaties allow companies or individuals who plan to (i) engage in substantial trade between the U.S. and the treaty country or (ii) invest a substantial amount in the U.S., to benefit from an E-1 Treaty Trader or E-2 Treaty Investor visa, respectively.

Requirements

To be eligible, the U.S. entity must be owned, for at least 50%, by citizens of the same treaty country as the employee (for instance, Germany) who cannot be a U.S. resident, or by companies ultimately owned by citizens of such treaty country.

- For the E-1 Treaty Trader visa, it must be established that a substantial trade (through exchange of goods and/or services) exists between the U.S. entity and the treaty country.

- For the E-2 Treaty Investor visa, a substantial amount proportional to the proposed activity (which can also consist of the acquisition of an existing U.S. entity) must be invested into the U.S. entity, which must produce a comprehensive business plan with financial and U.S. workforce hiring projections over the next five years.

Other general requirements generally include physical premises and operations in the U.S. (which can be in a start-up phase). The visa applications are directly processed at the U.S. Embassy or consulate in the treaty country (for Germany, at the U.S. Consulate in Frankfurt).

Duration

The U.S. entity can be granted Treaty Trader or Investor status for up to five years and such status can be renewed indefinitely as long as the U.S. entity is still in operation. Investors/owners and their employees in a managerial, executive or specialist capacity can benefit

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from E visa status as long as they are citizens of the same treaty country. Also, spouses of E visa holders are eligible for a specific work authorization valid for the duration of their visas and renewable.

E visas are a great tool to transfer employees from your home country to the U.S. If you would like to learn more about E visas or other U.S. immigration benefits such as L-1, H-1B, O-1 visas or permanent residence (Green Card), please do not hesitate to contact us by email or telephone: ERNST & LINDER LLC, Hervé N. Linder, 212-488-1672, linder@el-law.com; Dr. Marcus A. Ernst, 212-488-1668, ernst@el-law.com.

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Obama Administration releases FY 2011 Budget and States on International Tax Proposals

On February 1, 2011 the Obama Administration released its FY 2011 Budget. On the same day the Treasury Department released the General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals (so-called Greenbook). The Treasury Department estimates that its international tax proposals in the FY 2011 Budget will raise approx. $123 billion over 10 years (which is significantly less than what was included in the FY 2010 budget).

Compared to the FY 2010 Budget two new international proposals are contained and one international proposal has been dropped. The original proposal to modify the check-the-box regime for entity classification in certain scenarios has been dropped. Government officials have indicated that "engagement" with business leaders has caused the Administration to "focus their efforts elsewhere". On the other hand the definition of subpart F income would be expanded to include "excess returns" from the transfer by a U.S. person to a related controlled foreign corporation (CFC) of intangibles in certain circumstances. In addition deductions for excess non-taxed reinsurance premiums paid to affiliates of U.S. insurance companies would be disallowed.

The FY 2010 Budget proposal deferred certain deductions (other than R&D expenses) of U.S. persons that are allocable to deferred foreign source income. However, the FY 2011 Budget limits the deductions subject to the proposal to only interest expenses. Thus, sales, general, and administrative expenses are excluded from the expenses that may be deferred if allocated and apportioned to deferred foreign source income. The FY 2011 Budget does not change with regard to the foreign tax credit pooling and the foreign tax credit income matching proposal which has already been contained in the FY 2010 Budget. The FY 2010 Budget also extends certain expiring provisions through 2011. In particular, the active financing and look-through exceptions of §954(h) and §954(c)(6), respectively, are extended for an additional two years.

It seems that the Administration had taken the business community's concerns into account when developing the FY 2011 Budget. Especially the decision to drop the proposal to modify the check-the box-regime has found a positive echo. Based on the tie of votes between Republicans and Democrats in the Senate and the still pending health care reform it is currently unclear when and how the FY 2011 Budget proposal will pass the legislation process and enter into force. The Joint Committee on Taxation's analysis and revenue estimates for the Administration's new proposal are expected for March 31, 2010.

This analysis may provide additional information with regard to the recent proposals.

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The New German Accounting Modernization Act – A brief Introduction

As of January, 1st 2010 Germany enacted significant changes to its accounting rules; the "Accounting Modernization Act", in German "BilanzrechtsModernisierungsGesetz" (BilMoG, moving closer to International Financial Reporting Standards (IFRS). Most of the new rules become effective for reporting periods starting after December 31, 2009, some were enacted retroactively. BilMoG does not change the obligation for listed German Companies to report their group financial statements under IFRS. Unlisted companies have an option to apply IFRS instead of German GAAP in their group accounts.

However, statutory accounts under German GAAP must still be prepared for individual entities exceeding certain size thresholds. Since dividend distributions are restricted to the equity reported in the German-GAAP financial statements of the distributing legal entity, the relevance of BilMoG for is obvious.

The most significant changes to **accounting principles** are:

- Internally-generated intangible assets may be capitalised
- Financial instruments classified as 'held for trading are to be measured at fair value, taking into account an appropriate risk adjustment (only applicable for financial institutions)
- Hedge accounting is codified more prescriptively Previously available options for recognising provisions for future expenses are eliminated
- Options for determining manufacturing costs of inventories are abolished
- Write-down options for fluctuations in carrying value of assets and other discretionary write-down options are abolished
- Certain optional provisions are abolished
- Provisions are to be discounted using a seven-year average discount rate set by the German Federal Bank, whilst taking account of cost and price increases
- Pensions provisions have to be discounted using a seven-year average dis-

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count rate set by the German Federal Bank while assuming a 15 a residual term of 15 years for all individuals participating in the plan. The use of the accounting method set out by the German Income Tax Code resulting in lower provisions is discontinued. As a result pension accruals might increase by more than 20%.

- There is a new option to capitalise net deferred tax assets including assets from accumulated tax losses and tax credits

- Previous options relating to the recognition of goodwill, valuation of construction cost and other areas are no longer available

With some exceptions, effects from the conversion to BilMoG generally impact the net income reported for the financial period, with conversion income and expenses both classified as extraordinary. Optional tax treatments which are not in accordance with German-GAAP do not anymore require to be recorded in the commercial books of a company to become tax effective; there is much less distortion from tax accounting, a significant step for improving the informational content of German GAAP financial reporting.

The reforms introduced by the German Accounting Modernization Act are far-reaching and take German GAAP a big step closer to IFRS; accounting rules differ from tax rules more than ever before. German-GAAP does now provide less room for judgement, and will offer a more objective view.

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Relying upon the Tax Treaty to Avoid U.S. Taxation

Many foreign corporations inadvertently find themselves subject to U.S. tax because the character and level of their U.S. activities resulted in a U.S. trade or business. The determination of whether a corporation is engaged in a U.S. trade or business is generally based upon an analysis of the facts and circumstances. However, even if a German corporation is held to be engaged in a U.S. trade or business, Article 7 of the U.S-German Income Tax Treaty ("the Treaty") can be used to avoid U.S. taxation if certain requirements are met.

Under Article 7, Germany has the exclusive jurisdiction to tax business profits of a German corporation. However, there is an exception to this rule if the entity maintains a "permanent establishment" ("PE") in the U.S. In such cases, the U.S. is entitled to tax the business profits of the entity, but only to the extent such profits are "attributable to" that PE. Therefore, an important planning tool is to examine the activities of the company in the U.S. to determine whether a claim could be made under the Treaty that a PE does not exist.

Article 5(1) of the Treaty defines a PE as a "fixed place of business through which the business of an enterprise is wholly or partially carried on." Therefore, in order to have a U.S. PE, the enterprise must have a "place of business" in the U.S., the place of business must be "fixed", and the business of the enterprise must be carried on "through" this fixed place of business. However, even if these conditions are met, the enterprise nonetheless will not be considered to have a PE if the activities carried on through such fixed place of business are limited to auxiliary or preparatory activities. To this end, Article 5(4)(e) provides that the term PE does not include "the maintenance of a fixed place of business solely for the purpose of advertising, of the supply of information, of scientific activities, or similar activities that have a preparatory or auxiliary character for the enterprise".

Under this treaty-based exception to PE status, activities that, although they may contribute to the productivity of the enterprise, they "are so remote from the actual realization of profits that it is difficult to allocate any profit to the fixed place of business in question". The decisive criterion in making such a determination is whether or not the activity "forms an essential and significant part of the activity of the enterprise as a whole".

German corporations and their tax advisors should review their current or planned U.S. activities to see if a treaty-based position could help avoid a PE in the U.S.

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Multi-State Income Tax Issues for Businesses

In the United States, state tax laws differ in many ways from the federal taxation laws. When operating a corporation in multiple state locations there is the need to understand "nexus". Nexus is defined as the level of business activity that must exist before a company is subject to tax in a state.

States have varying rules on nexus, but nexus will always apply in the state of incorporation or where real or tangible property is owned or rented. Many states have expanded this list to include leasing intangible property, sales of services, owning goods on consignment or owning stock held in a public warehouse, an office in a salesperson's home, accepting orders or securing order deposits within a state, and repair and maintenance of business products, to name a few. Additionally, businesses that are listed in the phone book and deposits of funds within a state may also be factors. Other states have differing rules on licensing of software or intangible rights, as well as hiring, training or supervising employees in a state.

Activities protected from federal interstate commerce law which does not create specific nexus to a state, involve missionary sales activities, advertising campaigns incidental to those sales, checking customer inventory levels, and others. However, certain states have created laws ambiguously which may seem contradictory to the federal law.

After determining that a business has nexus within a state, there are differing ways each state will tax the business depending on whether it is a corporation or limited liability company. The most common measurement allocation activities are three pronged: sales within a state, the amount of payroll and the ownership of tangible property, including inventories, property and equipment, and use of rental property. There is no uniform state principle in how these are weighted in the allocation formula. Some states do not conform to a net income tax but to a gross sales or gross profit tax. Each state makes its own rules.

There are numerous planning opportunities which arise when assisting the client in their strategic development and even within certain states. For example, if a manufacturer has shipments out of state then sales within the state will be low and reduce the allocation factor for the state on sales. Some states have a threshold for shipping goods into their state whether or not there are active sales, property owned or personnel employed.

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LLC owned by a Corporation – What are the State Registration and Filing Obligations

Since its introduction, the limited liability company (LLC) has become a favorite entity choice for both foreign and domestic investors with US operations. Compared with alternative entity choices, the corporation, the S corporation, and partnerships, the LLC has a number of advantages. The S corporation is not available to non-residents and non-US citizens. The corporation offers limited liability and centralized management but triggers two levels of taxation. The general partnership has one level of tax but unlimited liability. The limited partnership offers one level of tax and limited liability butonly if the limited partners do not directly manage the business. The LLC's advantages are clear, the ability to obtain limited liability and one level of tax while still allowing individual investors to directly manage the business.

Once the benefits of a US LLC are selected, another set of issues arises. The US benefits come with additional problems for the foreign member (owner). The most common issue is the characterization of the LLC for foreign tax purposes. In some countries, treatment of the LLC as a corporation or partnership depends on a set of characteristics similar to those used in the US prior to the check-the-box entity classification election. In other countries such as the United Kingdom and Canada, a US LLC will always be treated as a corporation, regardless of its US tax classification. The characterization is further complicated when the LLC has a single member and elects or defaults to disregarded entity status under US tax law. This issue becomes especially significant in the often confusing world of US state taxation.

Assume, for example, that a foreign corporation is the sole member of a US LLC that elects or defaults to disregarded entity treatment for US tax purposes. Assume, too, that state tax law treats the LLC in accordance with its Federal tax classification, as a disregarded entity.

Two issues arise - which entity should register with the state for authority to conduct business in the state, and which entity or entities should register with the state tax authority for income and franchise tax purposes. The complication for the foreign member/owner arises because the answers to these two questions are unlikely to be the same for any two states.

For example, the Secretary of State expects to register the entity that will conduct business in the state, the LLC, which is still a separate entity for corporate law purposes. But the foreign parent must register for tax purposes since the LLC is disregarded as a separate entity. Even worse, in some states both the parent and the LLC must register for taxes.

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The Importance of Estate Tax Domicile for the Foreign National

With the final version of estate tax law in question for 2010, it would be helpful to review a key issue for foreign nationals who are resident in the United States and are not citizens or green card holders. Such individuals will be referred to in this article as either resident or nonresident foreign nationals. The article also assumes that the law will be changed for 2010 so that the effect on a foreign national will be similar to the law in 2009.

The significance of establishing domicile for US estate tax purposes cannot be overstated. Take the case of an executive who has been seconded to the US for a short-term stay of three to five years. If a noncitizen of the US dies while resident in the US, domicile becomes a critical factor in determining his US estate tax liability.

If it is determined that his domicile was in the US, then he will be taxed on his worldwide assets. Depending on whether he engages in certain transactions, he possibly will be subject to gift and generation skipping transfer taxes as well.

Contrast this with the case of the foreign national residing in the US who can show that his or her domicile for US transfer tax purposes is outside of the United States. In this case the executive would be subject to estate tax only on the fair market value of their US situs assets on their date of death. Depending on their country of domicile or the terms of a tax treaty, a credit for the estate tax paid to the US might be available to reduce their home country estate tax. Further, in the case of a nonresident foreign national, the estate tax exemption is only $60,000, a number that does not provide much shelter. It certainly provides incentive to avoid owning any US situs assets.

One way a nonresident foreign national can avoid or minimize the tax consequences of US situs assets, is by structuring ownership in such a way that the asset is deemed not to have a US situs. For example, the foreign national can form a foreign holding company (which in turn can be owned by a foreign trust) that acquires US real estate. Under US tax law, shares issued by a foreign corporation are not considered US situs property and so are exempt from estate tax for the nonresident foreign national.

One of our recent cases involved a decedent who had worked in the US for a long period of time and under the objective test for US income tax purposes, was a resident alien and filed US income tax returns, reporting his worldwide income. However, when his circumstances were reviewed, we were able to convince the Connecticut tax authorities that his estate tax domicile was in Canada. In Connecticut you do this by filing a Form C-3 (in New York, Form ET-141). The IRS reviewed the domicile affidavit and agreed that he was a nonresident alien for US estate tax purposes, allowing a significant amount of assets to avoid the tax net.

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