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CHOICES OF U.S. ENTITIES FOR INBOUND INVESTORS

Foreign investors desiring to acquire or establish a business in the United States are faced with a multiple choice of entities. This article identifies some of the most popular entity structures which foreign investors and business owners often use and some advantages and disadvantages of each.

C Corporations

A “C” corporation is often a more attractive alternative to foreign business owners than to U.S. owners. Because C corporation profits and losses do not flow through to its owners, foreign owners generally do not need to file U.S. income tax returns. Instead, the corporation itself is liable for federal corporate income tax (at rates up to 35 percent) and files IRS Form 1120. Although dividends paid out of current or accumulated earnings and profits to a foreign shareholder are subject to U.S. withholding tax at a rate of 30 percent, this rate could be significantly reduced if favorable treatment is available under a tax treaty. Furthermore, gain on the liquidation or sale of stock of the C corporation by a foreigner generally is not subject to U.S. tax, with the exception of U.S. real property holding companies (unless the corporation first sells all of its assets in taxable transactions and takes certain other steps).

Limited Liability Companies and Partnerships

Some foreign investors in U.S. real estate, or other areas when capital gain may be generated, will invest through a U.S. pass-through entity (perhaps first through a foreign trust) to take advantage of lower U.S. long-term capital gain rates.

1. Limited Liability Companies

Two developments in the last 20 years have greatly expanded the choices for structuring such investments or businesses. The first was the introduction and gradual acceptance of limited liability companies (LLCs). The second was the adoption by the IRS of the "check-the-box" regulations allowing taxpayers to elect to classify many non-corporate business entities either as C corporations or as flow-through entities for U.S. tax purposes. Under these regulations, an eligible entity is classified either as a C corporation, a partnership if it has more than one member, or, if it is owned by just one person or entity, a "disregarded entity” (DRE).

As a DRE, an LLC can be useful in limiting its owner's legal liability (to the assets held in the LLC) while preserving "flow-through" income tax treatment. These two factors, combined with a lack of restrictions on types of owners and relative flexibility regarding profit and loss allocations, have made LLCs a popular choice of entity in the U.S.

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However, if the LLC is treated as a partnership for U.S. tax purposes, a foreign member's "allocable share" of profits will be subject to tax, and the partnership is required to remit "withholding" tax on the allocated income, whether or not any cash is distributed. The LLC must annually file IRS Form 8804, Annual Return for Partnership Withholding Tax, to report the withheld tax. Foreign and domestic partners must also report their shares of the LLC's income or loss on their own federal income tax returns.

Beginning on January 1, 2017, foreign owners of entities treated as disregarded for tax purposes and wholly owned by foreign persons must file IRS Form 5472 to report their U.S. activities. Failure to file Form 5472 results in an initial penalty of $10,000 per entity.

2. Limited Partnerships

A limited partnership (LP) consists of one or more general partners with unlimited liability, and one or more limited partners with liability limited to their respective capital contributions. Like flow-through LLCs, an LP is required to "withhold" U.S. income taxes on foreign partner allocated profits. Moreover, while an LP will be treated almost identically to multi-member LLCs under U.S. tax law, it may be regarded differently under the tax law of the foreign owner's residence country.

3. Limited Liability Partnerships

A limited liability partnership (LLP) is similar in form to an LP, except it does not require a general partner – but does require at least two limited partners. Typically, LLPs are slightly less complicated and less expensive to set up than LPs – but do not differ much from LPs with respect to available "flow-through" income tax treatment and limited liability for partners. Similar to LPs, an LLP will be required to "withhold" U.S. income taxes on foreign partner allocated profits and may also be regarded differently under foreign tax laws.

Given the complexity of U.S. tax laws in this area, foreign persons should consult reputable tax advisors and legal counsel before making any decisions with respect to inbound investment structures.

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BUSE HEBERER FROMM

Capping Top Executives' Salaries Is Again on the Agenda in Germany

In Germany the electoral campaign is already in full swing. General elections are scheduled to take place in late September 2017. This may be one of the reasons why the discussion on capping of executive pay is on the agenda again.

In late February, the social democrats (SPD) presented a draft parliamentary bill which aims at capping the annual executive pay per employee at 500,000.00 euros, however, indirectly: according to these plans, companies shall only be allowed to deduct salaries, including bonuses and other fringe benefits, as expenses from their tax bill up to a maximum amount of 500,000.00 euros, per employee per year. Of course, the company may grant higher salaries but the exceeding amount shall not be tax-deductible and, therefore, would imply a much higher cost for the company than at present. However, to obtain the necessary majority in parliament to become a law this draft bill will need the conservative party's (CDU/CSU) support. The discussion is only just starting and it will probably become quite controversial as the campaign will gain momentum. Even constitutional concerns have already been raised. But unlike in previous situations, there seems to be a higher acceptance among politicians and the electorate alike, after so much news in the recent past of executives having been dismissed for bad performance but still been granted humongous bonuses.

In parallel to this discussion, a process of voluntary self-restriction is about to start in the German economy. Volkswagen, the world's largest car manufacturer, took the lead. The company just announced that it will put a cap on its top managers' salaries starting as of this year. The supervisory body approved the new rules: henceforth, VW's chief executive's total annual pay, including variable bonuses, will be capped at 10 million euros, and that of its other top managers at 5.5 million euros. Managers will lose their bonuses if the profit of the automaker will remain below 9 billion euros, or if the return on sales will stay under 4 percent.

There is also news from the banking sector's supervisory authority which may jeopardize top bankers bonus payments, even if already paid. As of March 1, 2017, according to the modified Remuneration Ordinance for Institutions *(Institutsvergütungsverordnung)* enacted by the German Federal Financial Supervisory Authority (better known by its acronym BaFin), in theory top bankers can be held liable to pay back bonuses if they have caused massive losses or are guilty of gross negligence ("claw-back"). By many insiders, however, this new regulatory tool is seen to be more of a paper tiger because the claw-back option needs to be implemented in the employment contract and therefore it can only take effect for new contracts. And even then, the criteria for a claw-back are defined in a way which leaves a lot of room for divergent interpretations.

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DE INTERNATIONAL The German Chamber Network

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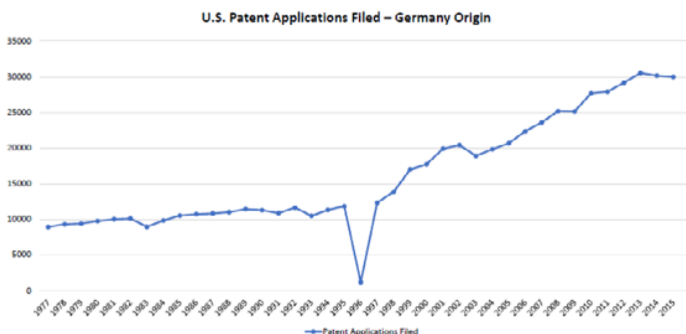
WUERSCH & GERING

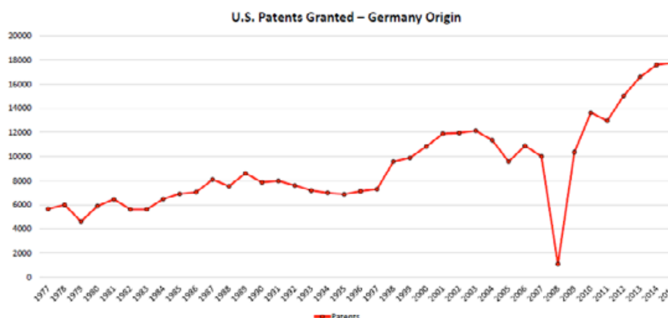
Status Update: Germany-Based Entities Building Intellectual Property (IP) Rights in the United States

Germany-based businesses and individuals, as well as others, have been procuring registered IP rights in the United States regularly for the past several decades. IP rights that can be registered or granted in the U.S. include patents, trademarks, and copyrights.

The U.S. Patent and Trademark Office (USPTO) publishes an annual Performance and Accountability Report. The 2016 Report (Report) shows that a record number of 650,411 U.S. patent applications were filed and 334,107 U.S. patents were granted in 2016. While the final numbers for 2016 have not been released, non-U.S. applicants have increased patent applications filings by more than 10% since 2012. Germany-based businesses and individuals have increased patent filings in the U.S. by about 3% since 2012.



Likewise, after a significant drop in patent grants in 2008 when the U.S. economy experienced difficulties, the number of patents issued to non-U.S. applicants and in particular Germany-based businesses and individuals continues to increase as well.



Often businesses or inventors file a U.S. patent application in the hopes of receiving quick examination results. However, the average time for receipt of a first action on patentability of the patent application is about 16.2 months after filing. This time depends

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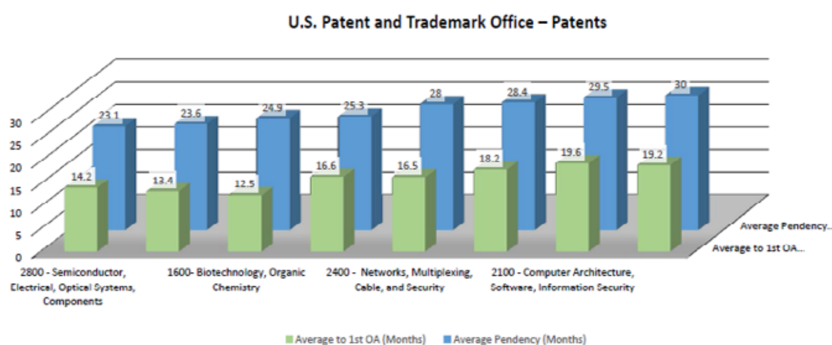
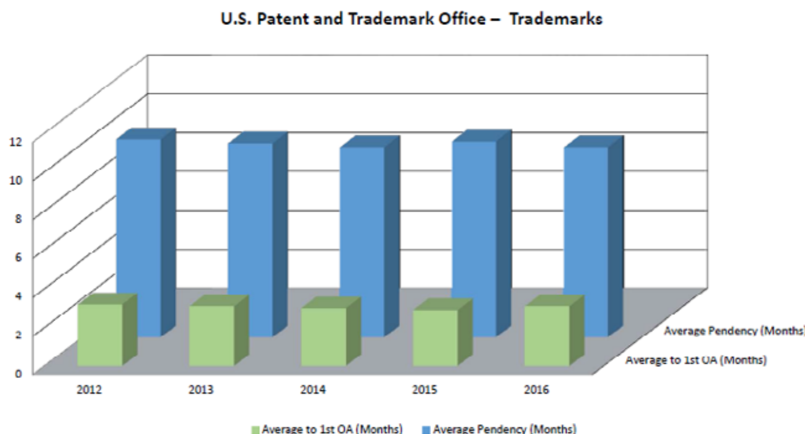
upon the technology area. For newly filed patent applications, the average pendency of the patent application process from filing date to final determination on the patentability – i.e., allowance, abandonment, or final rejection of the patent application – is about 25.3 months. The USPTO does offer an expedited examination process to those who fulfill specific requirements, in which case the time from filing to final determination is expected to be about 1 year. In order to achieve these much needed efficiencies, the USPTO has hired several hundred new Examiners, totaling 8,351 Patent Examiners and 570 Trademark Examiners as of the end of fiscal year 2016.



The procurement of a U.S. trademark is typically a much faster process, the current pendency being an average of 3.1 months to a first office action on the merits, and an average of 9.8 months to a final determination on the registrability of the trademark.



Germany-based businesses and individuals historically have obtained more U.S. patents in the chemical and pharmaceutical technologies than any other technology.

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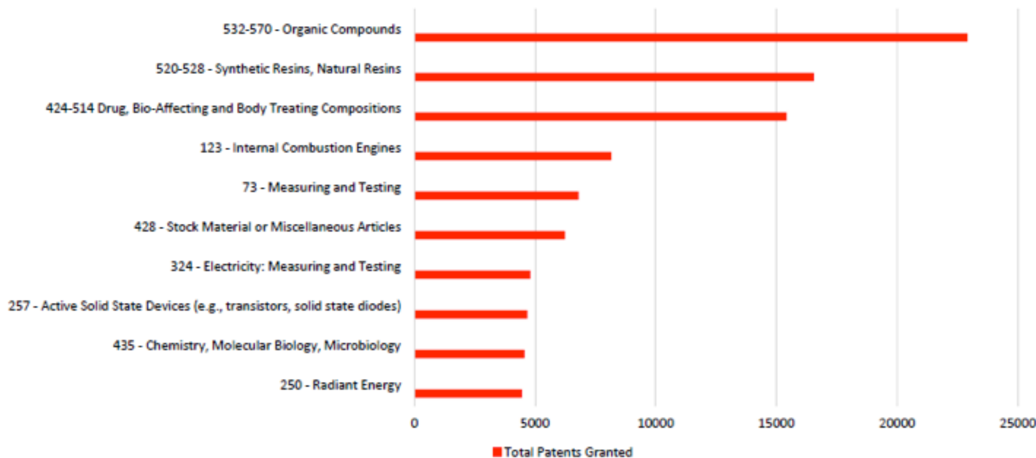

However, as Germany-based businesses have changed and technologies improved overall, the "top ten" industries in which Germany-based applicants have obtained the most U.S. patents now include more computer-based inventions, e.g., navigation and vehicle systems and data management.

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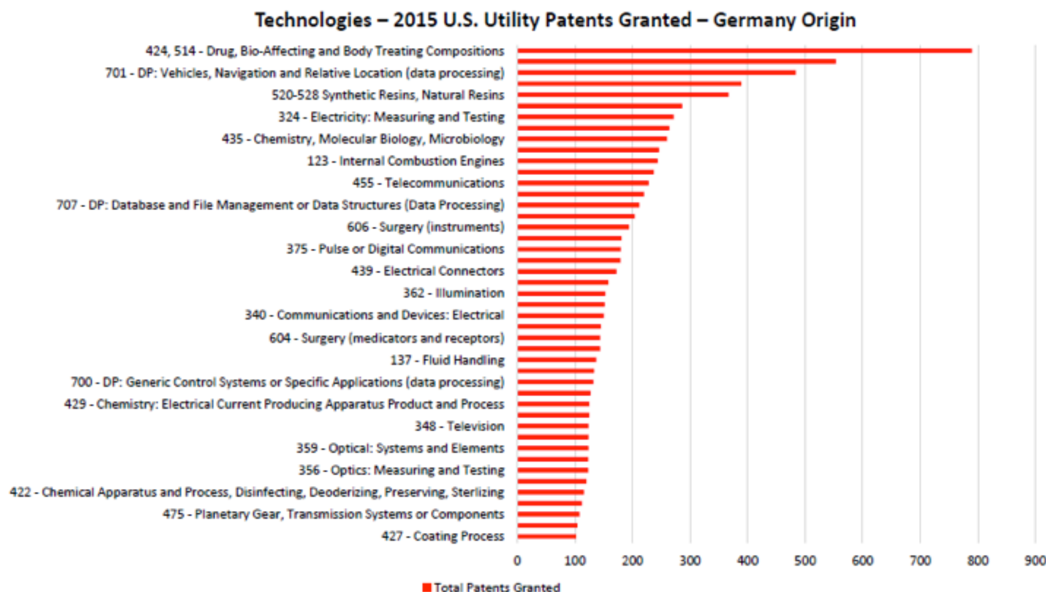

Businesses and individuals worldwide continue to file for more IP rights in the U.S. Strategic IP protection is an important tool in commencing, growing and maintaining a business, and requires knowledge of applicable U.S. statutes and caselaw and USPTO procedures and proceedings. If you would like more information regarding this or any of the above, please contact us at Wuersch & Gering LLP – a full-service law firm located on Wall Street in downtown Manhattan.

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BREXIT contravenes Unitary Patent Protection in the EU? "Yes, but ..."

Perhaps the most momentous development in the post-war European political landscape undoubtedly has been the UK referendum held on 23 June 2016 in which 52% of votes cast were in favor of leaving the EU. Much has been said about the numerous consequences the referendum by itself and certainly its implementation will have on the EU and undoubtedly for Europe as such. Although news appear to evolve rather erratically when it comes to the BREXIT, it appears as though the UK is prepared to actually trigger formal procedures for leaving the EU by invoking Article 15, i.e. to notify the European Council of its intention to withdraw from the Union.

Among the many potentially severe consequences such withdrawal may have, consequences on protection of Intellectual Property Rights in the EU have not been in the focus of general public attention. However, those that have been anticipating the advent of an attractive efficient way of protecting technical inventions in the EU as a whole (for the most part) will realize that BREXIT obviously, at first glance, is incompatible with the implementation and establishment of a Unitary Patent System.

The reasons are manifold. For example, the anticipated unitary patent protection system in the EU is designed to have a court system the highest instance of which is – the highest EU Court, the European Court of Justice! Presumably, the reasons leading to the result of the referendum most likely were not dominated by considerations revolving around patent law. Yet it would appear that the UK public that supports BREXIT would not be comfortable with the highest European Court having jurisdiction on the validity of patents conferring protection on UK grounds. Neither would that fraction be happy with the highest European Court having jurisdiction over whether certain acts taking place on UK soil are to be considered unlawful for infringement of a Unitary Patent.

Conversely, the pertinent stipulations governing the Unitary Patent Package provide for the Central Division of the Unified Patent Court to have a subdivision to hear cases related to chemistry including pharmaceutical and human necessities. The seat of said subdivision will be – London! Will the EU be comfortable with a court ruling on patent matters directly impacting the EU while being located outside of EU territory?

Finally, current stipulations provide for the specification of the agreement on Unified Patent Court by the United Kingdom in order for the system to come into force. Based on the aforesaid, ratification of the Unitary Patent Court system would appear to be the least action to be put on the agenda by any UK administrative body. Well, with developments in relation to BREXIT being as erratic as they are, perhaps quite surprisingly to many, on 28 November 2016 the UK minister for IP, Baroness Neville-Rolfe, at the EU

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BREXIT contravenes Unitary Patent Protection in the EU? "Yes, but ..."

competitiveness Council in Brussels issued a statement according to which the Unified Patent Court will be ratified by the United Kingdom.

If this statement remains to be the last statement concerning ratification, the way for the coming into force of the unitary patent system, in spite of BREXIT, would once again be cleared, provided such ratification were to take place while the UK is still member to the EU. In that case, however, if the UK, following ratification, eventually does leave the EU, mountains of challenging legal questions will arise regarding the fate of the Unified Patent system as such and regarding the fate of pending European patents with unitary effect. Certainly, academia in the law schools will be delighted at the prospect of research work on all open issues. Presumably, users of the system would have preferred a more straightforward course of action.

As of today, thus, the coming into force of the system can be expected in December 2017. Applicants should turn to their legal advisors regarding issues such as opting-out of the system, deliberately delaying grant of a pending EP application until the availability of the Unitary protection, but also regarding a critical review of e.g. any licence agreements, settlement agreements, agreements on jurisdiction etc.

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New York's Department of Financial Services Finalizes Cybersecurity Requirements for Financial Institutions – Requirements Also Impact Foreign Banks Operating in New York

On March 1, 2017, the New York State Department of Financial Services' (DFS) mandatory cybersecurity requirements for financial services entities became effective, with implementation to occur within 180 days (or by September 1, 2017). The requirements broadly cover all entities operating under or required to operate under DFS licensure, registration, or charter, or which are otherwise DFS-regulated, as well as, by extension, unregulated third-party service providers to regulated entities. This not only includes state-chartered banks, licensed lenders, private bankers, service contract providers, trust companies, and mortgage companies, but also foreign banks licensed to operate in New York and any insurance company doing business in New York. It does exempt small companies, though, including those with fewer than 10 employees, less than $5 million in gross annual revenue for three years, or less than $10 million in year-end total assets.

The regulation delineates various minimum standards and requires a risk-based cybersecurity program tailored to each company's specific risk profile. Significantly, the regulation requires covered entities to file an annual certification of compliance with the regulation; Certifications of Compliance will commence February 15, 2018.

DFS proposed similar regulations on September 13 of last year, but that set of regulations elicited significant feedback. Still, the regulations require potentially significant changes and focus on cybersecurity for many institutions.

Requirements

Generally, the regulation's requirements are focused on steps to increase security awareness and to encourage a risk-based, holistic, and robust security program at covered entities. To ensure compliance, covered entities must implement the following:

1. *Risk Assessments:* Periodic risk assessments that consider threats, particular risks to the entity, and an examination of existing controls in the context of identified risk.
2. *Cybersecurity Program:* The creation of a cybersecurity program based on the periodic risk assessments and designed to identify and assess risks; protect information systems and nonpublic information; detect, respond to, and recover from cyber events; and fulfill all reporting obligations. The program must include annual penetration testing and biannual vulnerability assessments. The cybersecurity program referenced

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here follows the general mandates of those delineated in the NIST Cybersecurity Framework.

3. *Cybersecurity Policies:* The creation and maintenance of written policies and procedures for the protection of information systems and nonpublic information and based on the risk assessment. These must include a written incident response plan
4. *CISO:* The designation of a chief information security officer to oversee the cybersecurity program.
5. *Minimum Standards:* Implementation of minimum cybersecurity standards, including systems designed to recover material financial transactions following an event and audit trails to detect events, the institution of appropriate access privileges, procedures for evaluating and testing the security of applications, multifactor authentication, data disposal, mandatory cybersecurity awareness training, and encryption measures.
6. *Third-Party Risk Management:* Implementation of a third-party risk management program, including a review of the cybersecurity practices of those providers and periodic assessment and audit thereof.

These new requirements, which are the first of their kind, signal an increased focus on risk-prioritized and managed cybersecurity. Please reach out to Jami Vibbert for guidance on ensuring compliance with the regulation.

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How a border adjusted tax system may affect German businesses in the US

As part of a broader tax reform effort, leaders of the U.S. House of Representatives proposed a controversial destination-based tax system with "border adjustments" (BAT). The current proposal is expected to generate significant revenue to fund reductions in nominal tax rate. Details about the mechanics of the BAT are yet to be revealed, and the policy debate is just beginning. However, both President Trump and the Congress want to stimulate domestic employment and have publicly endorsed imposing a tax on goods produced abroad and imported into the United States. Accordingly, there is a significant possibility that a provision containing some form of BAT may be enacted as part of tax reform.

In essence, a BAT would tax goods and services based on where they are consumed. Under the proposal described in the Blueprint, this would result in taxing imported goods and services while exempting exported goods and services from U.S. tax. From a European perspective the BAT is similar to an indirect tax such as a value added tax (VAT), however the BAT is intended to amend the federal income tax system and is arguable not an indirect tax.

While the Blueprint contains few details regarding the BAT, the proposal is likely based on a more detailed proposal from the report of the President's Advisory Panel on Federal Tax Reform (issued during the George W. Bush administration).

One of the key features of the BAT is an exemption for sales of goods and services outside the United States. Thus, a domestic manufacturer may exclude revenue from foreign sales from its tax base. However, while the taxpayer may deduct its domestic cost of goods sold, taxpayers may not deduct foreign cost of goods sold. In effect, a BAT would exempt exports from U.S. tax and subject imports to U.S. tax. As set forth in the report of the President's Advisory Panel, "Purchases from abroad are taxed by either making them nondeductible to the importing business or by imposing an import tax."

Under current U.S. tax law, a company that imports goods from abroad for resale in the United States or for incorporation in finished goods sold in the United States (such as retailers or domestic manufacturers) pays as much as 35 percent on the net profit from such resales, but the taxpayer may deduct its cost of goods sold regardless of source.

Under a BAT, the taxpayer's liability would change radically. Assuming the entirety of the taxpayer's cost of goods sold arises from import purchases and a corporate tax rate of 20 percent (the rate proposed in the GOP Blueprint), the taxpayer would not deduct its cost of goods sold in determining its federal income tax. The tax rate would essentially apply to gross sales revenue. Assuming gross sales of $10 million, cost of goods sold $8 million, the federal tax would increase from $0.7 million to $2 million.

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How a border adjusted tax system may affect German businesses in the US

A US manufacturer that primarily produces for export basically has a tax calculation under current law that is identical to that of the importer considered above. However, under the BAT the exporter's tax liability will differ substantially as compared to a taxpayer that imports inventory. For example, assuming an export manufacturer derives 80 percent of its sales from customers outside the United States, only 20 percent of its sales are even subject to tax. However, the manufacturer can still deduct its U.S.-based costs. As a result, the manufacturer may have a large tax loss, one that could be expected to recur every year, as long as the manufacturer's customer and cost base remains the same.

These two examples show the potentially dramatic implications of the proposed tax reform for companies with international supply chains and sales markets. Although, exchange rate shifts are expected to partially counter increased tax paid by importers, German exporters to the United States might still face huge competitive challenges under the proposed BAT. Taxpayers should begin to analyze the impact of the proposals as soon as a bill is introduced in the Congress, if not sooner.

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IRS Releases Initial List of Large Business and International Division Campaigns

The IRS Large Business and International Division (LB&I) on 31 January announced the identification and selection of 13 "campaigns" that will be the focus of the agency's enforcement efforts.

Last year, as part of its reorganization, LB&I announced that it would be implementing campaigns to identify the most serious tax administration risks, create specific plans to move toward expected compliance, and then deploy IRS resources accordingly. This initial wave of campaigns shows that LB&I is moving forward with its plan to focus on issue-based examinations and compliance. This approach is intended to make use of IRS knowledge and deploy the right resources to address those issues.

The initial 13 campaigns, as organized within LB&I's five substantive practice areas, are as follows:

- Treaty and Transfer Pricing Operations
  - Inbound Distributors
- Cross-Border Activities
  - Repatriation
  - Form 1120-F non-filers
- Withholding and International Individual
  - OVDP (Offshore Voluntary Disclosure Program) Declines–Withdrawals
- Enterprise Activities
  - IRC § 48C energy credit
  - Domestic production activities deduction, multi-channel video program distributors (MVPDs) and TV broadcasters
  - Micro-captive insurance
  - Related-party transactions
  - Deferred variable annuity reserves & life insurance reserves and Industry Issue Resolution (IIR) program
  - Basket transactions
  - Land developers – completed contract method (CCM)
- Passthrough Entities
  - TEFRA (Tax Equity and Fiscal Responsibility Act of 1982) Linkage Plan Strategy

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IRS Releases Initial List of Large Business and International Division Campaigns

- S Corporation Losses Claimed in Excess of Basis

The announcement stated that these campaigns were identified through LB&I extensive data analysis, suggestions from IRS compliance employees, and feedback from the tax community. LB&I's goal is to improve return selection, identify issues representing a risk of non-compliance, and make better use of limited resources.

The initial campaign rollout includes the inbound distributor campaign. Its goal is to verify whether inbound distributors receive an arm's length return rather than the losses or small profits some inbound distributors, especially in the middle market, have been earning. The IRS announcement describes the inbound distributor campaign as follows:

U.S. distributors of goods sourced from foreign-related parties have incurred losses or small profits on U.S. returns which are not commensurate with the functions performed and risks assumed. In many cases, the U.S. taxpayer would be entitled to higher returns in arm's-length transactions. LB&I has developed a comprehensive training strategy for this campaign that will aid revenue agents as they examine this IRC Section 482 issue. The treatment stream for this campaign will be issue-based examinations.

This campaign grew out of a pilot program called the Inbound Distributor Project, whereby the IRS determined that there was a widespread practice of not adequately compensating inbound distributors in the middle market.

The other 12 campaigns relate to non-transfer-pricing issues, although the related-party transactions campaign should be mentioned. That campaign will be overseen by the Enterprises Activities Practice Area, which generally focuses on domestic issues, and is described as focusing on transactions that provide taxpayers a means to transfer funds from a corporation to related pass-through entities or shareholders. Based on this description, the campaign will likely not relate to transfer pricing, even though the transactions at issue involve commonly controlled entities.

As noted in the TIGTA Audit released 3 November 2016, transfer pricing issues account for approximately 46 percent of the LB&I's international issues inventory and 71 percent of the potential total dollar adjustment amounts of all international tax issues. The focus on transfer pricing seems unlikely to change, even though only one transfer pricing campaign was announced in this initial rollout.

Going forward, therefore, it can be anticipated that more transfer pricing campaigns will be announced as LB&I continues to transition to its new approach. The new regulations under IRC §367(d) that were issued on 15 December 2016, along with the new IRS international practice unit released on 4 January 2017, may be a sign for campaigns to come.

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Nonresident Individuals with U.S. Rental Income – Consider the "Net Election"

There can be significant U.S. tax implications for foreign nationals owning real estate in the U.S. This article is going to focus on the taxation of rental income earned by nonresident individuals from U.S. property.

U.S. Tax Responsibility for the Nonresident Owner

The income earned from the rental of real property in the U.S. will always be U.S. source income subject to tax. However, the amount of the tax can depend on whether the income is considered to be investment income or if the nonresident alien is considered to be "engaged in a U.S. trade or business". Furthermore there is an important election known as the "net election" that can substantially reduce the amount of the final tax owed.

Foreign Person Considered to be "Engaged in a U.S. Trade or Business"- Ordinary Progressive Rates with Expenses Allowed to Be Deducted

If the taxpayer is considered to be engaged in a U.S. trade or business the rental income will be taxed at graduated income tax rates. The question of whether a taxpayer is considered to be engaged in a trade or business depends on the factual situation. Mere ownership of rental property is considered to be passive and will be taxed as discussed below. However, a foreign national whose activities in connection with the real property are deemed considerable, continuous, and regular can claim to be engaged in a trade or business in the U.S. and would be allowed to deduct expenses such as mortgage interest, depreciation, real property taxes, and repairs from the rental income. The individual taxpayer in this situation must estimate whether there will be net income from the rental property and make any estimated payments that will be due. In order to take expenses against the rental income a tax return must be timely filed on Form 1040-NR.

Passive Investors with Real Estate Income – Without "Net Election"

Passive rental income is taxed by a flat 30 percent withholding tax which is applied against the gross income from the property. No deductions are allowed. The result in this situation would be that the foreign national taxpayer would only receive 70 percent of the gross rental income. If the taxpayer is not otherwise required to file a U.S. tax return, no tax return is required to be filed under this scenario as there is no mechanism to recover any of taxes withheld on the rental income. Please note that any tax treaty between the

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nonresident taxpayer's country and the U.S. should be consulted to see if the Treaty modifies the 30 percent gross taxation of the rental income.

With Net Election under IRS Code Section 871(d)

Considering that the expenses connected with rental property can be significant, all foreign national nonresidents should consider whether it would be more advantageous to make an election under Code Section 871(d), known as the "net election". This election allows passive foreign investors to elect to tax rental income as if "effectively connected with a U.S. trade or business (ECI)" which would allow the taxpayer to take all applicable business deductions against the rental income. Graduated tax rates would apply, however, to the net rental income. The election must be made on a timely filed return. Procedures for making the election are contained in the IRS Treasury Regulations and require a statement with the return containing the following:

- A complete schedule of U.S. real property owned,
- An indication of the extent to which the taxpayer has direct or beneficial ownership of each item of real property,
- The location of the real property,
- A description of the substantial improvements on the property, and
- An identification of any taxable year or years in respect of which a revocation or new election has previously occurred.

The election applies to all real properties owned by the taxpayer in the U.S. and cannot be made for a year in which the taxpayer derives no income from the U.S. real property. The election remains in effect for each subsequent year unless it is expressly revoked with the permission of the IRS. If the election is made there would be no withholding requirement if the nonresident files the proper withholding form with the payor of the income indicating that the income is treated as ECI.

Please note that Treaties may also apply and may contain a different net election so nonresidents should be sure to consult treaty provisions. Also, the passive loss rules, which are beyond the scope of this article, may apply to limit current deduction of real estate losses. The Net Election can save nonresidents earning U.S. rental income a considerable amount of money and should not be overlooked.

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