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The forthcoming reform of the Renewable Energy Sources Act – a paradigm shift?

Background

The Renewable Energy Sources Act ("EEG") and its flanking regulations were designed to promote Germany´s shift towards a sustainable economy (so called "Energiewende"). This objective shall primarily be reached through an essential increase of the production of electricity from renewable energy sources, such as sunlight, wind, biomass and others ("EEG-electricity"). The EEG therefore provides a broad support scheme for power plants producing electricity from renewable energy sources ("EEG-Plant"). The responsible network operator is legally bound to connect EEG-Plants as a priority and to purchase, transmit and distribute the entire available quantity of EEG-electricity. Furthermore, the EEG provides a statutory guaranteed feed-in tariff ("FIT") for EEG-electricity for a period of 20 calendar years in addition to the commissioning year. The operator of the energy supply system an EEG-Plant is connected with is responsible for the payment of the FIT for the electricity delivered to its balancing account. Its exact amount depends on the type of the renewable energy source and further parameters. The FIT underlies a degression.

The FIT is usually higher than the price the grid operator would achieve on the stock exchange. The difference between the FIT and the (potential) price for the sale of EEG-electricity under market conditions on the EEX energy exchange, the cost-apportionment ("EEG-Umlage"), is generally passed on to the final customer. It is significantly limited for electricity-intensive manufacturing enterprises with high electricity consumption and rail operators upon request in order to maintain their international competitiveness. Currently, this partial exemption is on trial before the EU-Commission, which has started state aid proceedings on 18 December 2013. The operator of an EEG-Plant is entitled to market its energy by way of direct marketing – instead of delivering the EEG-electricity into the balancing account of the energy supply system operator for the FIT. The aim is to apply the EEG equalisation system to the market and thereby accelerate the market integration of electricity produced by EEG-Plants.

Reforming efforts

The total amount of the EEG-Umlage to be paid by each final customer depends on the share of EEG-electricity in the total power generation. Amongst other things, its expected increase has contributed to the government announcing a fundamental reform of the EEG, which shall come into force on 1 August 2014. Pursuant to a key issues paper of the government ("Eckpunktepapier"), which was published on 22 January 2014, the essential content of the revised EEG shall be:

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- cut the FIT from an average of 17 ct/kWh in 2013 to 12 ct/kWh in 2015;
- implementation of a technology specific expansion corridor (Ausbaukorridor) for renewable energy of 55-60 percent of the total power production in 2035;
- feed in tariffs shall underlie a wider degression and existing premiums shall be cancelled;
- from 1 August 2014, direct marketing shall become obligatory for new EEG-Plants producing more than 500 kW. From 2017 on, direct marketing shall be compulsive for all new EEG-Plants bigger than 100 kW;
- from 2017 on, EEG-electricity shall be supported by a tendering procedure, whereas such a bidding system shall first be tested by way of a pilot project regarding an open space photovoltaic system.

Outlook

Despite previous achievements, the Energiewende remains the objective for the time being. As it is vital that EEG-Plants can be operated profitably on market terms, they are perspectively supposed to be competitive without any funding mechanism applying. It remains to be seen whether the FIT persists or whether a paradigm shift towards a bidding system will be implemented by the revised EEG.

(Future) EEG-plant operators or investors should in any case keep track of the upcoming support framework for EEG-plants under the revised EEG, as the adapted legal framework may become decisive for the future profitability of EEG-plants in Germany and possibly in Europe. At the same time electricity-intensive manufacturing enterprises must keep an eye on the EU-Commission's state aid-decision regarding the partial exemption from the EEG-Umlage, which is expected in the course of 2014: Should it finally be qualified as a prohibited state aid, corrective payments in the amount of the previous exemptions could become due and there would be no such future exemptions. Hence, this could lead to a number of electricity-intensive manufacturing enterprises being no longer economically effective in Germany.

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Germany Brushes up on Design Protection (and Language)

As of 1 January 2014 an amended law governing the protection of designs in Germany has come into force.

The most prominent amendment that has become effective with the change of the year is not related to anything legal. Instead, the amendment is of a strictly linguistic nature in that the right conferred to applicants is now officially referred to as "Registered Design" *(eingetragenes Design).* Thereby, legislators have responded to the trend of decades of Germans to incorporate a growing number of English words into the German language. In fact, most German IP practitioners most likely will have found themselves in the past using the English word "design" in order to elucidate to a German client the meaning of the former official term *"Geschmacksmuster"* which nowadays evokes associations with the German word for flavor *(Geschmack)* in the context of gastronomy rather than with industrial designs. In this regard, it is understandable that the legislator has even taken the radical step of officially renaming even existing registered to German designs retroactively.

On the legal side, the amendment brings about the introduction of invalidation proceedings to be held before newly formed design invalidation divisions at the German Patent and Trademark Office. Typical grounds for invalidity will be the existence of prior design producing the same overall impression as the Registered Designs. With the introduction of invalidation proceedings, the German legislator is further concentrating expertise on the validity of IP rights at the German Patent Office which, in Germany, is already the case for patents and utility models.

An important consequence for enforcing Registered Designs in future infringement trials will be that the infringement courts may and in certain cases must stay the infringement trial until a decision has been reached in parallel invalidation proceedings before the German Patent and Trademark Office, this decision being binding for the infringement court to the extent that the same parties are involved. Formerly, a Registered Design in Germany could only be declared invalid by a civil court or on the basis of a counterclaim in infringement proceedings.

Generally, the separation of the validity case from the infringement case in accordance with the new law can be expected to further strengthen the legal position of holders of Registered Designs. Also, on a general scale, one can expect high quality and improved predictability of validity decisions relating to Registered Designs in Germany as a result of the concentration of such cases at the German Patent and Trademark Office – at least once the system is up and running. For the time being, it

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will be interesting to follow the first rulings by the newly established design invalidation divisions at the German Patent and Trademark Office.

Ironically, while the introduction of invalidation proceedings for registered German designs is following in the footsteps of existing procedures for Community Designs, linguistically the national German Design Law has now overtaken the Community level design protection which still uses the old-fashioned term *"Geschmacksmuster"* in the official German language edition of the relevant Community Regulation.

Beware Of Delaware: Some Dangers In Designating Delaware As The Forum For Dispute Resolution

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As an international lawyer representing foreign companies, I regularly meet with clients who want to incorporate or organize their U.S. operations in Delaware. But when asked, these clients never know the reason they prefer Delaware for incorporation or organization. The same lack of knowledge applies to designating Delaware as the forum for the resolution of commercial disputes. But, in my opinion, foreign parties should almost never designate Delaware as the forum for a trial or as the law to control in litigation or arbitration.

There are several reasons for this. The first is practical. While many companies organize themselves in Delaware, very few are actually physically located there. This means that the company's accountants, lawyers, employees, and management are all somewhere else. But if a trial is held in Delaware all these people must travel to Delaware to participate if needed. This is usually an enormous and wasted cost. Compounding this cost is the provision under Delaware law requiring you to hire Delaware counsel to represent you. Unlike other jurisdictions, Delaware law requires local counsel to participate in the drafting of all documents filed in court, to physically be in court for all court hearings, to actually physically file documents with the court, and to negotiate with the court and opposing counsel on trial dates, etc., often essentially doubling the number of law firms utilized in a litigation. In addition, only local Delaware counsel get official notifications of court dates and the opposition's court filings. This usually slows down your response, and takes precious hours, and sometimes days, from your response time. Thus, by law, in almost all cases involving companies not physically located in Delaware, legal, administrative, and executive costs involved in a litigation are needlessly multiplied, and time is usually unnecessarily lost: all this for no compensating benefit.

The non-Delaware-based party is also placed at a strategic disadvantage. Its executives are far from the courthouse; records and documents – even in the age of electronic documents – are more difficult to obtain, especially in an emergency; and internal consultations and decisions, which are often critically important in the midst of a fierce litigation, are harder to reach. This puts great pressure on the non-Delaware-based company to settle the case to its disadvantage.

In addition, Delaware courts are extremely protective of their jurisdiction and the applicability of Delaware law to the litigation. It is unlikely that a party not physically located in Delaware, and who has agreed to jurisdiction in Delaware, was advised by Delaware counsel before signing the agreement. Agreeing to resolve a case in Delaware courts usually is coupled with an agreement to apply Delaware law. But in most situations

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the party not physically located in Delaware does not know the implications of applying "Delaware law" in its agreement or case. Therefore, the party agreeing to apply Delaware law to its case rarely knows what it is really agreeing to.

Finally, Delaware courts tend to favor Delaware parties. This is not a favorable omen with which to begin or conduct a litigation, especially for a foreign-based or owned company.

In my experience, companies should designate Delaware as the forum for dispute resolution only in the rare situations which that may favor them. There is even less justification to designate Delaware law as the law controlling the contract. In general, foreign companies should designate Delaware as the forum or choice of law only when their U.S. operations are physically located in Delaware.

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Service Abroad By Email – Has The Time Come?

Serving a United States federal court complaint on a foreign corporation has never been easy. Service of process must comport with the U.S. Constitution's requirements of due process, which means that service must be reasonably calculated, under all the circumstances, to inform parties of the action and afford them a chance to be heard and object. Federal Rule of Civil Procedure 4(h)(2) authorizes, with limited exception, service of process on a foreign entity in the same manner prescribed for foreign individuals under Rule 4(f). Rule 4(f) provides several methods of service. The first (and commonly used) is service "by any internationally agreed means (…) such as those authorized by the Hague Convention." Fed. R. Civ. P. 4(f)(1). But service via the Hague Convention can be a long process. In some cases the country itself will object, even if they are a signatory, creating long delays and potentially blocking the initiation of a lawsuit even where, under U.S. law, jurisdiction over the corporation is clear.

There is another faster, less expensive method of service that may become more routine: email. Several courts in the last year have noted that email can, under certain circumstances, be used for service. Pursuant to Fed. R. Civ. P. 4(f)(3), a federal court has discretion to allow service by "other means not prohibited by international agreement." Several courts have ruled that email service is not "prohibited" by the Hague Convention or other international agreement. This is true even where some countries, such as Germany, have objected and opted out of certain types of service – such as by mail or through diplomatic channels – under the Hague Convention.

A recent case involving a patent claim illustrates the point. In that proceeding, *Lexmark International, Inc v. INK Technologies Printer Supplies, LLC,* 291 F.R.D. 172 (S.D. Ohio 2013), the plaintiff wanted to serve entities in China and Germany. The foreign defendants had not appeared, and no counsel had noticed an appearance on their behalf. Rather than trying to serve through the Hague Convention, plaintiff relied on Fed. R. Civ. P. 4(f)(3) and asked permission to serve the defendants via email. The Court allowed email service to proceed on the German and China corporations. The plaintiff demonstrated that the businesses maintained active websites and provided email addresses; and the plaintiff had used those email addresses to communicate with company representatives. There was no need, said the Court, to use Rule 4(f)(3) only as a "last resort" if Hague Convention service failed. Indeed, following established Hague Convention procedures was likely to cause delay.

The *Lexmark* case reinforces a growing trend among federal courts. In New York, for example, courts also appear open to the idea of service on foreign entities pursuant to Rule 4(f)(3). In one recent case, a court allowed service on a China corporation's U.S.

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Service Abroad By Email – Has The Time Come?

counsel even though China objected. In that case, plaintiff suggested service on the company by email, but the court found that unnecessary because the corporation's U.S. counsel had already appeared in the case, and the court therefore found that serving counsel would ensure proper notice. *Jian Zhang v. Baidu.com Inc.,* 85 Fed. R. Serv. 3d 1140 (S.D.N.Y. 2013).

There are some obvious potential problems with allowing service by email, as well as likely objections. Defendants may claim they never received the service, or that the wrong person opened and discarded the e-mail. There are also likely to be governmental objections to such a process, along with pressure by foreign corporations to disallow the practice, should it become commonplace. Counsel wishing to serve a complaint via email would be wise to use software to track delivery and under the rules need to seek court permission. Nevertheless, the pervasiveness of email as a form of communication in business today likely will make service pursuant to email extremely appealing to courts and plaintiffs. The speed of delivery and low cost are obvious advantages. Moreover, as courts and commentators have noted, several countries already allow email service in court proceedings, and it may be difficult for those countries to object when U.S. courts begin allowing such service. In short, given recent court rulings, it is likely to become more common for plaintiffs to seek permission from courts to serve a foreign entity via email.

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Obstacles On The Way To TTIP

The present discussions and negotiations of the Transatlantic Trade and Investment Partnership (TTIP) reflect one of the most ambitious projects between the European Union and the United States of America. The TTIP's objective is to remove trade barriers, such as customs and other tariffs, and to reduce, to the largest possible extent, differences in technical regulations, standards and approval procedures in the European Union and the US. The Trade Agreement aims at enhancing and simplifying trade between two regions of the world which already today accounts for a daily trade of goods and services worth 2 billion. According to estimations of the European Commission, TTIP has the potential to increase the economies of the European Union by 120 billion, of the US by 90 billion and of the rest of the world by 100 billion.

One of the core issues of TTIP is to protect foreign investments on both sides of the Atlantic. And it is true that this is also one of the most difficult areas to handle and to agree on. Investment protection provisions aim at fighting discriminations, expropriation which is not for a public policy purposes and not fairly compensated; unfair and inequitable treatment and, of course, to allow free capital transfer. Investment Protection Agreements usually provide for an investor-to-state dispute settlement, or "ISDS" system. ISDS is a very common part of investment protection treaties. However, in the most recent discussion it has come under scrutiny by people who fear that arbitration panels do not guarantee the necessary neutrality if multinationals can bring claims against national governments. The concern is that governments, when making new laws, may be influenced by potential pressure coming from multinationals and that this can have an adverse effect on their decision-making authority. In this context, some on-going prominent cases have caught the public attention such as Vattenfall vs. Germany and Philip Morris vs. Australia.

The Swedish energy multinational Vattenfall brought a claim against the German Government for its decision in 2011 to abruptly phase out of nuclear power generation. The tobacco multinational Philip Morris is suing the Government of Australia for its decision to ban brand names on cigarette packs for reasons of public health. Critics often bring forward the argument that arbitrators – for the most part they are lawyers but no regular judges – do not have the same commitment to the rule of law as is the case of judges in domestic courts. In an attempt to take the concerns regarding the investor-state dispute settlements into account, the European Commission decided on January 21, 2014 to consult the public on the investment provisions of a future EU-US trade deal. The public consultation intends to secure the right balance between protecting investment interests and upholding governments' rights to regulate in the public interest.

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Until now, the content of the TTIP negotiations is only known to the individuals involved in the negotiations. The European Commission, however, announced to make public the proposed text for the investment part of the talks, including sections on investment protection and on investor-to-state dispute settlement.

Lawyers involved in International Arbitration point out that arbitration proceedings are not “arbitrary” at all (in the literal sense of the word). Arbitration Tribunals, including those specialized on the settlement of investment disputes (like the one set up by the World Bank, or ICSID), have their own set of rules and are also under the scrutiny of the public since many of the arbitral awards have been published and, should the arbitrators not abide by the rule of law, an award may even be challenged before domestic courts. Therefore, it is absolutely essential that the investor-to-state dispute resolution part of TTIP ensures a clear set of procedures which guarantee an independent Arbitration Tribunal, highest possible transparency and a fair process.

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Mitigating Risk: Red Flags when doing Business in the U.S.

Red Flag 1: DEUTSCHE GERICHTSSTANDSKLAUSELN IN DEN USA

Folgende Formulierung sollte sinngemäß verwendet werden, um das Risiko abzuschwächen, dass ein US-Richter eine deutsche Gerichtsstandsklausel nicht anerkennt wegen der Notwendigkeit, in Deutschland zuerst die sich nach dem Streitwert zu berechnenden Gerichtskosten einzuzahlen zu müssen, um das Verfahren zum Laufen zu bringen. Denn in USA betragen die Gerichtskosten einen Bruchteil deutscher Gerichtsgebühren und sind unabhängig vom Wert einer Forderung.

Controlling Law, Jurisdiction. This Agreement will become effective only after it has been signed by Distributor and has been accepted by XXX at its principal place of business, and its effective date shall be the date on which it is signed by XXX. It shall be governed by and construed in accordance with the laws of the State of Germany, excluding the Convention on Contracts for the International Sale of Goods and that body of law known as conflicts of laws. Venue is YYY. Distributor consents to the enforcement of any judgment rendered in Germany in any action between Distributor and XXX. Any and all defenses concerning the validity and enforceability of the judgment shall be deemed waived unless first raised in the District Court of YYY. The parties approve that the acceptance of the forum YYY, Germany is reasonable, fair and conscionable, also in light of the different legal systems and the request by courts to advance court fees before any suits are served to the other party.

Red Flag 2: HAFTUNGSDURCHGRIFF

Viele deutsche Unternehmen beschäftigen sich im Rahmen der geplanten Gründung einer US-Tochtergesellschaft mit der Frage, welches Haftungsrisiko sie als Gesellschafter mit dieser Beteiligung eingehen. Zwar verhält es sich mit der Haftung der Gesellschafter einer Gesellschaft mit beschränkter Haftung in den USA grundsätzlich nicht anders als in Deutschland, d.h. die Haftung z.B. einer Corporation (Inc.) ist in der Regel auf das Vermögen der Gesellschaft beschränkt, jedoch lassen US-Gerichte in Ausnahmefällen einen Haftungsdurchgriff („Piercing the Corporate Veil") auf die Gesellschafter bzw. die Muttergesellschaft zu. Nachfolgender Auszug aus einem US-Urteil soll Ihnen Anhaltspunkte geben, wann ein US-Gericht von einem sogenannten Alter Ego ausgehen kann und damit zur Bejahung einer Durchgriffshaftung kommen könnte.

1. Commingling of funds and other assets of the corporation with those of the individual shareholders;

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2. diversion of the corporation's funds or assets to non-corporate uses (to the personal uses of the corporation's shareholders);
3. failure to maintain the corporate formalities necessary for the issuance of or subscription to the corporation's stock, such as formal approval of the stock issue by the board of directors;
4. an individual shareholder representing to persons outside the corporation that he or she is personally liable for the debts or other obligations of the corporation;
5. failure to maintain corporate minutes or adequate corporate records;
6. identical equitable ownership in two entities;
7. identity of the directors and officers of two entities who are responsible for supervision and management (a partnership or sole proprietorship and a corporation owned and managed by the same parties);
8. failure to adequately capitalize a corporation for the reasonable risks of the corporate undertaking;
9. absence of separately held corporate assets;
10. use of a corporation as a mere shell or conduit to operate a single venture or some particular aspect of the business of an individual or another corporation;
11. sole ownership of all the stock by one individual or members of a single family;
12. use of the same office or business location by the corporation and its individual shareholders;
13. employment of the same employees or attorney by the corporation and its shareholder(s);
14. concealment or misrepresentation of the identity of the ownership, management or financial interest in the corporation and concealment of personal business activities of the shareholders (sole shareholders do not reveal the association with a corporation, which makes loans to them without adequate security);
15. disregard of legal formalities and failure to maintain proper arm's length relationships among related entities;
16. use of a corporate entity as a conduit to procure services or merchandise to another person or entity;
17. diversion of corporate assets from the corporation by or to a stockholder or other

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Mitigating Risk: Red Flags when doing Business in the U.S.

person or entity to the detriment of creditors, or the manipulation of assets and liabilities between entities to concentrate the assets in one and the liabilities in another;

18. contracting by the corporation with another person with the intent to avoid die risk of nonperformance by use of the corporate entity; or the use of a corporation as a subterfuge to illegal transactions;

19. for formation and use of the corporation to assume the existing liabilities of another person or entity.“

Als eine seit über 20 Jahren auf deutsches und U.S.-amerikanisches Unternehmensrecht spezialisierte Wirtschaftskanzlei (nunmehr auch auf China und UK ausgerichtet) verfügt NIETZER & HÄUSLER über entsprechende Erfahrungen im Umgang mit US-Klagen und berät Sie gerne bei der Abwehr entsprechender Ansprüche in Deutschland und den USA.

Often Overlooked: Tax Obligations when Owning Shares in a Non-U.S. Company which is a „PFIC“

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If a U.S. citizen, greencard holder or other U.S. tax resident holds an investment in a foreign company which has passive income (e.g., dividends, interest, rents), the foreign company may qualify as a Passive Foreign Investment Company (PFIC). Its income may be subject to U.S. taxes even if it has not been distributed to the individual and the individual may have certain U.S. reporting obligations.

Some examples for typical fact patterns involving PFIC issues are:

- Einstein lives in the U.S. and is the CFO of Zweistein Inc. He owns stock (say 5%) in the Inc.'s German holding company, Dreistein GmbH, which owns all subsidiaries worldwide and receives dividends from them.
- Markopolo has been assigned by his employer in Germany to work in the U.S. for a number of years. He owns some shares in a German open-ended investment fund (mutual fund) which generates passive income.
- Kleopatra resides in her Florida beach house most of the year. She holds her German rental properties through several German GmbH & Co. KGs all of which are treated as corporations for U.S. tax purposes.

Why do Einstein, Markopolo and Kleopatra own shares in a PFIC?

A foreign company (corporation or other company which is non-transparent for U.S. tax purposes) is a PFIC if it meets either of the two tests below.

1) Income test: 75% or more of the company's gross income for its taxable year is passive income (e.g. dividends, interest, royalties, rents, and annuities, among a few others).
2) Asset test: At least 50% of the average percentage of assets held by the company during the taxable year are assets that produce passive income or that are held for the production of passive income.

How are the U.S. shareholders of a PFIC taxed?

Generally, the U.S. doesn't tax foreign business income derived by a foreign corporation with U.S. shareholders until the corporation makes a dividend distribution. Certain rules, however, eliminate the benefit of deferral of U.S. tax on income derived through foreign corporations. These rules include the PFIC regime.

U.S. shareholders of PFICs pay – in general - tax and an "interest" charge on the receipt of "excess" distributions and upon the disposition of PFIC stock. Excess

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Often Overlooked: Tax Obligations when Owning Shares in a Non-U.S. Company which is a „PFIC“

distributions are the portion of the distribution received during the current tax year that is greater than 125% of the average distributions received during the 3 preceding tax years (or the holding period if less than 3 years). Absent certain elections, gain recognized on the disposition of stock in a PFIC or on receipt of excess distributions is treated as ordinary income and as earned pro rata over the shareholder's investment holding period.

As alternative to the general rule, U.S. shareholders may elect to treat the PFIC as a qualified electing fund ("QEF") or to be taxed under the mark-to-market rules applicable to marketable PFIC stock. If an election is made to treat the PFIC as a QEF, then each U.S. shareholder, must generally include his or her share of the PFIC's total income in gross income on an annual basis. As a practical matter it may be difficult to obtain information regarding the earnings of the foreign corporation computed on a U.S. tax basis.

Finally, a shareholder of a PFIC may make a mark-to-market election for marketable PFIC stock. Under the mark-to-market rules, U.S. shareholders currently take into account as income (or loss subject to certain limitations) the difference between the fair market value and their adjusted basis of the stock as of the close of the tax year.

What reporting obligations do U.S. shareholders of a PFIC have?

Generally, a U.S. person that is a direct or indirect shareholder of a PFIC must file, for each PFIC separately, a Form 8621 for each tax year it owns any percentage of the shares of a PFIC. There are certain exceptions from filing which are not discussed herein. Note that the statute of limitations does not begin to run for a tax return that does not include the required PFIC reporting.

Ownership of a PFIC can create traps for the unwary. Taxpayers should analyze their investments and consult with their tax advisors to ensure proper reporting of their foreign holdings, including PFICs.

Report of Foreign Bank and Financial Accounts (FBAR) – considerations for the 2013 report.

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June 30 is the deadline to report foreign financial accounts. This seems to be still far away, but assuming that we have just celebrated the New Year and suddenly find ourselves with already three months of 2014 left behind us, it is a good idea to start early gathering the necessary information. This is especially true because starting July 1, 2013 there have been changes in the reporting process.

But let's take a step back first and have a look at the general filing requirements.

Who must file a FBAR?

The FBAR filing instructions state: "A United States person that has a financial interest in or signature authority over foreign financial accounts must file an FBAR if the aggregate value of the foreign financial accounts exceeds $10,000 at any time during the calendar year."

Let's break down the requirements for further explanation:

A **United States (US) person** does not only mean US citizens and green card holders, but also includes US residents and entities (corporations, partnerships, LLCs, trusts etc.) created and organized under the laws of the US.

Being the owner of record or holder of the legal title of accounts represents **financial interest.** Additionally, having the power of disposal of the accounts due to signature authority also constitutes a reporting requirement; for example, controlling shareholders of a US company are deemed to own the company's foreign financial accounts and would need to report those accounts on their personal FBAR in addition to the reporting requirement of the company itself. A lowly employee who has signature authority over the foreign accounts of the US company would need to report the same accounts on a separate FBAR as well.

Besides foreign bank accounts the reporting of **foreign financial accounts** also includes investments such as securities accounts, brokerage accounts, insurance policies with a cash surrender value and certain non-US retirement plans. FBAR reporting is required if the total maximum value of each the accounts during the year is equal to or higher than $10,000. The maximum value needs to be determined in the local currency and then translated for reporting purposes in US dollar using the official December 31, 2013 Treasury Reporting Rates of Exchange.

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Example:

Peter, a German citizen living in New York City since 2012, is the owner of three personal bank accounts in Germany. Two of the accounts are jointly owned with Anne, Peter's wife. Both Peter and Anne are US permanent residents for income tax purposes. Anne does not have any other separately owned accounts in Germany. Additionally, Peter is a controlling shareholder of P Corporation, the US subsidiary of German P GmbH fully owned by Peter. The aggregate value of the accounts exceeds $10,000.

Peter needs to report on his 2013 FBAR firstly the information on the one German bank account owned separately from his wife. Secondly, he needs to report both accounts owned jointly with Anne. Anne would file her own FBAR showing the joint accounts.

Lastly, Peter needs to determine, if he has signature authority over any foreign bank accounts owned by P corporation or P GmbH. If so, the account information and owner information needs to be included in his FBAR reporting as well.

Why is the filing of the FBAR required?

The FBAR reporting goes back to the Bank Secrecy Act (BSA) of 1970. The law was introduced due to the government's concern that US taxpayers use foreign financial accounts for money laundering and tax evasion. It empowers the US Department of Treasury's Financial Crimes Enforcement Network (FinCEN) to maintain financial transactions information on a national and international level. FinCen administers FBAR compliance.

When is the FBAR due?

FBARs for all taxpayers are filed on a calendar year basis.

The 2013 FBAR needs to be received by FinCEN on or before June 30, 2014. There is no extension available; one should plan accordingly to assure timely filing. Extensive civil as well as criminal penalties may apply for failure to file the FBAR.

What are the changes in the reporting process?

IRS Form 90-22.1, which has been used for the FBAR reporting in prior years, is now FinCEN Form 114. Starting July 1, 2013 mandatory e-filing is required for the FBAR through the FinCEN BSA E-Filing System. FBAR filers need to create a profile on the FinCEN website and enroll in the e-filing process.

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Additionally FinCEN issued FinCEN Form 114(a), Record of Authorization to Electronically File FBARs, which is used to authorize a third party to file the FBAR on behalf of a US person. It does not need to be filed with FinCEN, but will be kept in the records of the FBAR filer and the authorized third party. In consequence, if a tax return preparer is taking care of his clients' FBAR reportings, the clients need to provide him with the signed FinCEN Form 114(a).

ParenteBeard can help you determine your filing obligations with regard to foreign financial accounts. Please contact us to discuss the application of these rules to your situation.

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New York State 2014/2015 budget outlines tax reform proposals

On January 21, 2014 New York State Governor Andrew Cuomo released the 2014/2015 executive budget. As expected, the Executive Budget includes many of the tax reforms and tax reductions included in the reports of the Governor's Tax Reform and Fairness Commission and Tax Relief Commission. Among other reforms, the budget proposes significant changes to the bank franchise tax and the general corporation franchise tax. In particular, the governor's proposals would repeal the bank franchise tax in its entirety and merge it into a significantly modified general corporation franchise tax. Key components of the reform package include unitary filing, economic nexus, repeal of subsidiary capital treatment, changes to the definition and taxation of business and investment income, market-based sourcing, and preferential treatment for certain manufacturers.

It is important to mention that most of the proposed reform items would only impact filing obligations in New York State, and not in New York City. Accordingly, if conforming changes are not made to the New York City Administrative Code, taxpayers may be faced with two different tax regimes in the State of New York and the City of New York. As a result, without substantial conformity, the City of New York will lose its access to relevant New York State tax audit changes and will have to greatly expand its own corporate tax audit effort. As the New York City Administrative Code differs significantly from the New York State tax rules (e.g. New York City taxes unincorporated businesses and S-Corporations as well as C-Corporations) full conformity could be costly.

Significant corporate tax proposals, which generally would be effective for taxable years beginning on or after January 1, 2015 are the following:

- Adopting an apportionment formula based on a single receipts factor using customer sourcing rules;
- Adopting full water's-edge unitary combined reporting with an ownership test of more than 50% and providing for a new combined group 7-year election for certain commonly owned groups;
- Expanding the application of economic nexus in determining whether corporations are subject to tax so that corporations with sales to New York customers of $1 million or more would be subject to tax;
- Eliminating the additional tax on subsidiary capital and certain existing exclusions for income from subsidiaries while retaining an exemption for dividends from unitary subsidiaries;

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- Using federal tax law effectively connected income concepts (without regard to tax treaties) as the starting point in determining New York entire net income;
- Requiring that all captive insurance companies be subject to unitary combination;
- Repealing the "tax treaty" exception to the royalty add-back provisions;
- Repealing the alternative minimum tax, but increasing caps on the alternative taxes based on New York source gross receipts and on allocated business capital;
- Modifying existing expense attribution rules by limiting attribution of expenses to interest expense and by creating a safe harbor whereby taxpayers may elect to reduce total investment income by 40% in lieu of subtracting interest deductions directly or indirectly attributable to investment capital or investment income.

For foreign investors the proposed adoption of the economic nexus standard might be of special interest. The respective foreign corporation's tax would be computed based on effectively connected income (ECI) without regard to tax treaty benefits, rather than the current apportioned worldwide income approach. It should however also be noted that potential Federal legislation would overrule this proposal: the "Business Activity Tax Simplification Act of 2013" would, if enacted in its present form, codify a so-called "Physical Presence" standard for state and local income and other business activity taxes, thus nullifying the economic nexus standards not only for New York State tax purposes but in general.

The proposed budget also includes a proposal to increase the exemption from New York estate taxation to $5.25 million on an individual's estate, indexed for inflation. In addition, the top estate tax rate would be reduced from 16% to 10%. The proposed changes would be phased in over a four-year period and would become effective on April 1, 2014.

Applicable to taxable years beginning on or after January 1, 2014, the Governor's proposal also includes a two-year property tax freeze delivered to taxpayers in the form of income tax credits.

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Self-Directed IRA – Alternative Investment Options but Beware!

In the aftermath of the "Great Recession" and the search for greater return on investment given the extremely low interest rate environment that has been the norm for many years now, investors looking for alternative options to bond and equity products may find it useful to establish a self-directed IRA.

The IRS regulations require that a qualified trustee/custodian hold the IRA assets on behalf of the owner, maintain and safeguard the assets, keep records of transactions, comply with reporting requirements, issue statements to the client, ensure that the client understands the rules regarding prohibited transactions and perform other administrative functions for the life of the IRA.

The asset selection can include the usual mix of bonds, equities and mutual funds, but what makes it especially attractive is the ability to invest in a wide variety of alternative asset classes, such as precious metals. Certain assets are forbidden, e.g., investments in life insurance, certain collectibles such as art, rugs, antiques, metals, gems, stamps, coins (with some exceptions), wine and other tangible property. Assets the IRA can hold include various types of real estate, stocks (domestic and foreign), mortgages, partnership interests, and precious metals (coins and select bullion). One caveat with real estate: a client recently wanted to use IRA funds to buy real estate and obtain a mortgage to help fund the purchase. The seller was fine with that except he wanted the buyer to give a guarantee which would cause the debt to be recourse. This is a type of prohibited transaction and caused the transaction to fall through. Nonrecourse debt is permitted, but it may trigger UBTI (unrelated business taxable income).

As with everything in life, along with the good, comes the bad. There are a comprehensive number of transactions which are prohibited and which result in a horrific penalty regime. The regulations are intended to prevent the owner, or a beneficiary, or other disqualified person from engaging in certain transactions that would cause an improper use of the value in the account. These rules apply to all the different types of IRA's out there, including Roth IRA's and their purpose is to prevent self-dealing or conflict of interest transactions that would directly or indirectly benefit the IRA holder or a disqualified person. Such persons include the owner, a fiduciary, certain family members, service providers, certain entities owned by a disqualified person or joint ventures with same, and for certain IRA's, employers, officers, directors, shareholders and highly compensated employees.

Examples of some prohibited transactions with an IRA include borrowing money, selling property, receiving compensation from an IRA owned asset, guaranteeing a loan,

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buying property for personal use, receiving a credit card, using real estate owned by the IRA and paying for personal expenses.

Some of the more difficult outcomes have arisen in the context of investing IRA funds in a business venture. While this can be a great source of funds for a start-up business that's not managed by the IRA owner, there are pitfalls.

The rules against self-dealing have a broad reach. In ***Rollins v. Commissioner,*** T.C. Memo 2004-60, a CPA loaned money from his 401(k) to three companies in which he held non-controlling interests. Despite the fact that the loans were at a market rate and the company's assets were secured, the IRS deemed the transactions to be prohibited and that the loans benefitted Mr. Rollins. The consequences of engaging in such a tainted transaction are extreme, the IRA is treated as distributing its assets at fair market value at the beginning of the year and the 10% early withdrawal penalty as well as ordinary income taxation will result, as well as any prohibited transaction penalties.

In a more recent case, ***Peek,*** 140 TC No 12, Tx Ct Rep (CC) 59535, decided in 2013, the IRS prevailed, with the court holding that a loan guarantee was a prohibited transaction as a direct or indirect lending of money or extension of credit between an IRA and a disqualified person. The taxpayer had used IRA funds to acquire assets from another corporation through a newly established corporation they controlled. In the acquisition, debt arose, which they personally guaranteed. The court held this to be an indirect extension of credit and so the IRA was broken with attendant tax consequences.

The bottom line is that while it may be possible for an entrepreneur to use an IRA to fund a start-up venture, care must be taken to avoid breaking the IRA and accelerating tax consequences.

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New U.S. Cybersecurity Framework Likely to Become Baseline Standard

On February 12, 2014, the Obama Administration released the first version of its new voluntary cyber security framework pursuant to a presidential executive order issued one year ago in response to Congress's failure to pass cybersecurity legislation. The Framework for Improving Critical Infrastructure Cybersecurity does not instruct companies what to do or what tools or applications to use. Rather, the Framework generally represents a compilation prepared by the National Institute of Standards and Technology – working with the Homeland Security Department and industry stakeholders – of known, publicly vetted standards that can be applied to identify, protect from, detect, respond to, and recover from risks. Some may criticize the Framework as containing little that is ground-breaking or new, but a significant part of its purpose is to create a shared vocabulary for discussing and describing cybersecurity that can be used by a broad range of companies in different industries to create and evaluate risk-management programs. Through the Framework, critical gaps in programs can be identified and plans tailored to meet the specific needs for each user.

Application and Framework Structure

Although the Framework is voluntary, critical infrastructure owners need to recognize that, if a company's cybersecurity practices are ever questioned during a regulatory investigation and litigation, the baseline for what is considered commercially reasonable is likely to become the Cybersecurity Framework. The Department of Homeland Security defines critical infrastructure companies broadly to include banking and finance, communications, critical manufacturing, the defense industrial base, energy, emergency services, food and agriculture, healthcare, information technology, utilities, and transportation systems. These companies should be prepared to document and demonstrate that their cybersecurity practices are consistent with the practices promoted through the Framework.

The Framework is built on three basic components:

Core. A set of common activities that should be used in all programs, providing a high-level view of risk management.

Profiles. These help each organization align cybersecurity activities with its own business requirements, and to evaluate current risk management activities and prioritize improvements.

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Tiers. Tiers allow users to evaluate cybersecurity implementations and manage risk. Four tiers describe the rigor of risk management and how closely it is aligned with business requirements.

Government incentives for adoption are expected to include public recognition, cybersecurity insurance and cost recovery programs. In addition, regulatory agencies are working to ensure that existing regulations correspond with the Framework, and government procurement requirements are likely to include conformance to the Framework for contractors and suppliers.

Assistance to Private Sector

The Department of Homeland Security is actively encouraging adoption of the Framework by the private sector and has launched a voluntary Critical Infrastructure Cyber Community program. The DHS Secretary has indicated that the program will provide a “single point of access” to the department’s cybersecurity experts for anyone needing assistance. One of its services, the Cyber Resilience Review, has already been widely used by industry. Through the review process, organizations can evaluate their own programs and determine if they are in line with the practices and standards of the Framework.

Conclusion

The Cybersecurity Framework is just a first step in creating a cybersecurity guide for the nation’s critical infrastructure sectors and establishes an important precedent by defining common security standards. It also brings together for the first time a useful set of federally endorsed practices for private sector security. It standardizes the questions all CEOs should ask about their companies’ security practices as well as those of their suppliers, partners, and customers. Moreover, the Framework is likely become the de facto standard for private sector cybersecurity in the eyes of U.S. regulators and lawyers. Companies are therefore advised to document their compliance in order to be ready to demonstrate their cybersecurity practices are consistent with the practices promoted through the Framework.

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