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The German Chamber Network

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New Developments in German Corporate Governance

The German Corporate Governance Code has been adopted by a Government Commission in 2002 for the first time. It aims at making Germany's corporate governance rules more transparent for both national and international investors and was introduced as an answer to increasing international criticism against corporate governance in Germany. Critics were bringing forward that German corporate life was inadequately focusing on shareholder interests, that corporate governance was not transparent and German supervisory boards were lacking independence, among others.

The Corporate Governance Code has since been amended from time to time. The most recent changes have been introduced in July 2010. One of the more interesting changes for foreign investors in listed German stock companies is the continuing evolution of the term "diversity" ("Vielfalt") used to determine the composition of both the Management Board ("Vorstand") and the Supervisory Board ("Aufsichtsrat").

The relevant paragraph 4.1.5 of the Corporate Governance Code reads: "When filling managerial positions in the enterprise the Management Board shall take diversity into consideration and, in particular, aim for an appropriate consideration of women." However, the meaning of the term "diversity" has not been defined in the Corporate Governance Code. It seems to imply that namely in international German businesses the Management Board shall include members who are either foreigners or have international experience and that a higher number of women shall be appointed. Basically, the same criteria apply for the composition of the Supervisory Board (para 5.4.1 Corporate Governance Code). The latest amendment of the Corporate Governance Code also introduces the requirement that the Supervisory Board specify "concrete objectives regarding its composition" and, again, take into account "the international activities of the enterprise" and stipulate "an appropriate degree of female representation."

The Corporate Governance Code, however, does not establish any rigid rules when it comes to implement the required "diversity" at the two different management levels in German stock corporations. The Supervisory Board is invited to determine members of the Management Board (and its own members) in accordance with the necessities and circumstances of the company while it is desirable to appoint more members with international experience and to increase the number of female members. Supervisory and Management Board of listed stock corporation will have to take decisions on these issues before they give the next declaration of conformity with the recommendations of the Corporate Governance Code (which has to be published once a year).

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Corporate Governance

Corporate governance issues are again at the forefront of today's business headlines. With the devastating news regarding the viability of certain U.S. corporations and the demise of others in the United States appearing almost daily over the past year and a half, the management of corporations has once more become the focus of many news reports and television shows, as well as our legislators.

With all the legislative reform initiatives either passing through or being proposed by Congress and the various state governments, a board of directors and management of a German company with U.S. investors or the U.S. subsidiary of a German company could very easily find themselves overwhelmed with attempting to be proactive and taking into account the many different requirements that may impact the way a corporation will need to conduct its affairs. While we believe that it is part of good management to be informed of proposed changes, the board of directors must still comply with its ongoing fiduciary obligations and look out for the best interests of the corporation, as does management.

Accordingly, until some of these contemplated changes become law, boards and management must continue to operate as required under current law, but with an eye on the pending reform and, of course, the requirements of the German parent. With respect to U.S. requirements, the board of the U.S. company can, as in the past, continue to rely on the "business judgment rule." The "business judgment rule" doctrine provides a sturdy safety net for the board when rendering its decisions, provided that it has acted in good faith and in an informed manner, was rational and has acted without self interest.

In light of changes demanded by investors and legislators regarding, among other items, executive compensation and risk management, and the likelihood that some changes thereto will become law, we think it would be prudent for U.S. subsidiaries of German companies and German corporations with U.S. investors or U.S. operations to re-examine their past practices in these areas and try to determine what would be considered "best practice" on a going-forward basis.

To date, the courts, primarily in Delaware, have supported boards using the business judgment rule, but in the upcoming year, there will be more objections from shareholders as they question various board decisions. Both the board of directors and management of U.S. subsidiaries of German companies and German corporations with U.S. investors or U.S. operations will have to be careful while navigating the myriad of corporate governance changes that will most certainly arrive in our near future.

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Loss Carry Backs

Foreign investors with operations in the United States that have experienced losses for tax purposes should review whether those losses can be carried back to recover income taxes. The Worker, Homeownership, and Business Assistance Act of 2009 allows taxpayers to elect to carry back arising in years ending after December 31, 2007 and before January 1, 2010 for up to 5 years. Normally, losses in the US can be carried back only 2 years always to the oldest year first. These rules apply to individuals, corporations, corporate groups, estates, and trusts.

Several of the normal rules and procedures for losses have been relaxed under this legislation. First, the rules with respect to Alternative Minimum Tax (AMT) have been modified so that AMT will not prevent recovery of tax in most cases. Second, the amount of the loss that can be carried back to the fifth preceding year is limited to 50% of the taxable income in that year. This rule does not diminish the overall loss carry back but does limit the amount of loss that can be used in the fifth carry back year. Third, even if the taxpayer has filed an irrevocable election to carry forward losses, the taxpayer can break those elections under these new rules.

The loss carry back can be made in two ways, that is a previously filed return may be amended by filing a appropriate form (Form 1120X for corporations) or by way of a tentative carry back adjustment (Form 1139 for corporations). An amended return is procedurally straight forward but is subject to audit which may delay receipt of the refund. A tentative carry back adjustment procedure may be advantageous in that it requires the Internal Revenue Service to act on the claim within 90 days. The Internal Revenue Service makes a limited examination to discover omissions and errors of computation and then applies the refund to any unpaid tax and remits the balance if desired.

A taxpayer must file an election statement with the taxpayer's original or amended federal income tax return for the taxable year of the applicable loss year on or before the due date (including extensions) for filing the return for the taxpayer's last taxable year beginning in 2009. The election is irrevocable and, in general, may be made for only one taxable year. The statement must state that the taxpayer is electing to apply § 172(b)(1)(H) under Rev. Proc. 2009-52, and that the taxpayer is not a TARP recipient nor, in 2008 or 2009, an affiliate of a TARP recipient. The statement must specify the length of the NOL carryback period the taxpayer elects (3, 4, or 5 years).

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Red Flags when doing business with the U.S.

When doing business in or with the United States, whether with U.S.partners or through your own subsidiary or some other intermediary or just being the consultant located outside the U.S. but assisting a U.S.citizen, you must be aware of the far reach of U.S.jurisdiction. The following samples shall serve as red flags and a reminder for having foreign corporate management and compliance consultants do their homework. Extraterritoriality (applicability of U.S.laws to facts and circumstances, persons and companies outside the U.S.) is an issue your company must be willing to cope with when doing business on a U.S, and global scale.

Sample 1:

Germany will assist the U.S. Department of Justice in a request for extradiction in cases of alleged infringement of the Foreign Corrupt Practices Act. See Official Statement of the DOJ, July 2010: An Italian citizen, a former executive of a Californian based valve company has been extradited to the United States from Germany in connection with his alleged participation in a conspiracy to secure contracts by paying bribes to officials of foreign state-owned companies as well as officers and employees of foreign and domestic private companies.

Sample 2:

U.S.sanctions against foreign companies when delivering blacklisted products to Iran. See Official Statement of the DOJ, July 7, 2010: A federal grand jury in Washington, D.C., has charged an Irish trading company, and its Irish officers in Ireland, in a superseding indictment with purchasing F-5 fighter aircraft parts, helicopter engines and other aircraft components from U.S. firms and illegally exporting them (via Malaysia) to (not officially mentioned to the U.S.party) Iran. Apart from the order, the defendants had no contact to the United States. Thus, get the necessary information first from the U.S. Office of Foreign Assets Control (OFAC). Be aware that your company is even then subject to OFAC's reach if not doing business in the United States but having a German Management Board to which a U.S.Citizen is a member to.

Sample 3:

Swiss Lawyer Indicted for Helping to Hide Swiss Bank Accounts and Monies Returned to U.S. Clients. See Official Statement of the DOJ, July 15, 2010: A federal grand jury in Alexandria, Va., returned an indictment charging an attorney practicing in Zürich, Switzerland, with conspiring to defraud the United States and structuring the importation of currency into this country. If convicted, he faces a maximum sentence of 25 years in prison

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M&A' Red Flags for the United States

and a maximum fine of $1.25 million. Thus, watch out not to forget to file FinCen Form 105, Report of International Transportation of Currency or Monetary Instruments, with the Bureau of Customs and Border Protection when you intend to physically transport, mail or ship, or cause to be physically transported, mailed, shipped or received, currency, traveler's checks, and certain other monetary instruments in an aggregate amount exceeding $10,000 into the United States.

Blog USA: www.usa-recht.de www.gerichtsreporter.us

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Recent Changes In Patent Practice

The world of Intellectual Property changes continuously and needs a survey on a regular basis to keep pace with changing trends and thereby avoiding serious mistakes.

Especially in the field of software related inventions, e.g. business methods, changes have recently taken place. In the United States, the decision of the CAFC in re BILSKI has led to a severe change in the treatment of such inventions, even rendering granted US-patents void. Although the Supreme Court will have to decide upon this matter, applicants will have a harder time as hitherto to obtain software related patents. The United States may have lost their status as being the Happy Isles for applicants seeking protection for business methods.

Applicants in other countries had to face this problem earlier.

The President of the European Patent Office has asked his highest Board, the Enlarged Board of Appeal in 2008 to consider a set of questions concerning the patentability of software related inventions. Although the Enlarged Board of Appeal has now rejected the questions as being not admissible, it has given some answers in the course of the assessment of admissibility (May 15, 2010 – G3/08). The Enlarged Board of Appeal has answered the question, whether a computer program has to be excluded as such for not being technical, if it is explicitly claimed as a computer program. Answering this question, the Enlarged Board of Appeal stated that an application may avoid exclusion merely by explicitly mentioning the use of a computer or a computer-readable storage medium. Nevertheless, the invention will still fail to be patentable for lack of inventive step. Another question was, whether a claimed feature must cause a technical effect on a physical entity in the real world in order to contribute to the technical character of the claim, thus being grantable. It must not since all of the claimed features together determine whether the claimed subject-matter has a technical character. In a nutshell, it is not necessary to also claim a machine to obtain a patentable claim under the European Patent Convention.

Both answers of the Enlarged Board of Appeal are in line with the above mentioned CAFC decision in re BILSKI according to which a successful machine-or-transformation test will result in patentability. In both territories, a machine has not to be claimed for obtaining a patent on a software related invention. What is necessary is that the claimed software handles data representing transformations of physical subjects like structures of bones or alike.

Both, the European and the US decision will lead to a more unified practice in the world of patents thereby reducing the number of completely surprised applicants looking crestfallen with unexpected refusals in their hands.

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IP-Licences in German Insolvencies

Imagine, you run a company that produces, say, mobile phones. Your latest model is a huge success with your customers because it contains a state-of the-art technology from a German developer you just bought the IP-license from. Now, maybe because you – as a savvy businessperson – negotiated such a low price for the licence, the German licensor has gone broke. As a consequence, under German law, the licensor must file for insolvency protection. The next thing you know, you find a letter on your desk from a so-called insolvency administrator, i.e. the bankruptcy court-appointed officer who assumes the management duties of the directors and officers of a bankrupt company. In this letter, the insolvency administrator, among other things, candidly declares that he chooses to select the "non-performance" of the IP-licence pursuant to section 103 of the German Insolvency Code (Insolvenzordnung, "InsO"). Section 103 InsO enables the insolvency administrator to discontinue agreements that have not yet been fully performed by the contracting parties in case the continuation of which would be detrimental to the debtor's estate. In plain English, that means the licence you bought was just revoked and you have to stop selling your product if you do not want to risk an IP-infringement suit commenced by the estate of the bankrupt licensor. Even though this scenario may strike you as very foreign to US-Bankruptcy law, it is really not: You would have faced the same scenario dealing with a US-licensor prior to the enactment of section 365(n) US Bankruptcy Code in 1988.

Consequently, it is essential for licensees of German-based IP, to do everything they can to render their respective license agreements as "insolvency-proof" as they can. There is no general court-approved concept of how to establish an IP-licence that does not fall under the ability of the insolvency administrator to elect its non-performance, mainly because any circumvention of section 103 InsO is prohibited and voided pursuant to section 119 InsO. However, there are a number of options that can be employed according to the characteristics of the respective case. If the licence is exclusive and irrevocable and the consideration is fully paid upfront, the licence is less likely to be perceived as a contract that has not yet been fully performed, and thus would not fall under section 103 InsO. Alternatively, a full transfer and assignment of the licensed right under the condition precedent of the termination of the licensing agreement can be contemplated. Lastly, in cases of bigger licensing portfolios, it might make sense to incorporate a separate single purpose company, possibly as a joint venture between the licensee and licensor, to which the licensed IP is transferred. No matter how you approach the situation, it is imperative to address the issue for every single license you obtain from German licensors.

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Maintaining a Leading Edge in an Open Innovation

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Cooperation with business partners as a way to save time and reduce R&D cost is in vogue. The "not invented here" syndrome is giving way to open innovation, joint ventures, and strategic alliances. What does this trend mean for companies sharing technology with other companies internationally? What are the risks? What is the role of intellectual property (IP) in such a setting?

Let's take the story of a German company called "Stolz Innovativ*" which discovered an important technical breakthrough. After applying for patent protection, Stolz's inventors met a new product development manager from a U.S. company called "Fox Manufacturing*" interested in commercializing this new development. Fox wanted to conduct some tests to see whether it met its commercial viability criteria. To pursue that aim, the companies signed a basic non-disclosure agreement (NDA) and Fox started conducting tests as agreed.

From time-to-time, Stolz asked Fox about the status of its tests and offered to provide support. Fox replied that it would report the outcome as soon as evaluation of the test results has been completed.

Eight months later, Fox reported that it had conducted further development work based on Stolz's discovery on which it filed for patent protection. Since Fox's patent application was based solely on its in-house development work and Stolz's patent application which in the meantime had been published in the normal course, Stolz could not prove that Fox violated the NDA via a disclosure in its patent application. There was also no basis on which Stolz could claim joint ownership of Fox's invention.

Although Fox operated solely in the US, it filed for patent protection internationally. Since the claims in Fox's patent applications appeared to be patentable, Stolz was, in the absence of a license from Fox, blocked from using Fox's technology – even in Germany. Based on this leverage, Fox was able to negotiate a favorable exclusive global cross-license agreement. Stolz had no incentive to further develop the technology in view of Fox's patent position. Eventually, Fox acquired Stolz.

What started out as a promising endeavor resulted in a one-sided outcome due to Stolz's implicit trust that Fox would act in the spirit of cooperation. Fox's behaviour, on the other hand, is not surprising to those who grew up in a capitalist society.

As an American lawyer, I can show you simple and effective negotiating measures you can take to clarify the motivation of your U.S. technical cooperation partner and, when appropriate, how to use IP rights as leverage to establish a fair and robust business relationship.

* A fictitious name. Any resemblance to the name of a real person, company or product is coincidental.

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The Contractual Forum Selection Clause

While parties entering into a contract neither desire nor expect a dispute to arise, the potential for a future conflict remains a very real possibility. Given this possibility, parties conducting international trade, commerce and contracting often find it helpful and necessary to have an understanding as to where they may be haled into court should some future conflict result from their deal. Generally, a forum selection clause drafted into a contract allows these parties to predetermine what jurisdiction will hear a potential legal dispute if such a dispute were to occur. For example, if a German hotel and its guests sign a form of agreement designating the German courts to be the forum of choice, this provides one aspect of certainty to an otherwise uncertain deal. It can prevent a defendant from being subject to unfamiliar and feared jury trials and extensive and expensive discovery processes or class action lawsuits frequently available under the American judicial system.

The U.S. Supreme Court had repeatedly upheld such clauses and has encouraged the federal courts to do the same. In The Bremen v. Zapata Off-Shore Co., 407 U.S. 1 (1972), the Court held that a "forum clause should control absent a strong showing that it should be set aside." Thus, the Court created a presumptive validity for forum selection clauses that could be overcome only where the party opposing it can show it is unreasonable under the circumstances or that procurement of the clause was surrounded by fraud or overreaching.

Courts are often called upon to interpret a contract's forum selection clause based on the language used. One particular element they must examine is whether a clause is mandatory or permissive. It is mandatory if designated as the "exclusive" forum and in some cases, even if the word "exclusive" is not present, it is mandatory. In such a case, the action is required to be brought in the designated forum. However, if the clause is determined to be permissive, then the action is not required but may be brought in the stated forum. In either event, such designation gives jurisdiction to the designated court, subject to appropriate notice. It may also be deemed to be a consent to application of the law of that jurisdiction. The federal circuits are split as to whether a forum selection clause implicates procedural law, or substantive law, which might determine enforceability under state or federal law. Another consideration includes establishing what specific types of claims will be covered by a forum selection clause.

Past judicial decisions in federal and state courts highlight the importance of a carefully drafted contract with an unambiguous forum selection clause and how important it is to consult counsel with corporate experience with German clients in this and related fields.

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Practical Advice for Negotiating Agreements

In my experience as an international lawyer, many of the same issues arise in deal after deal. Here are some of my observations and advice on how to deal with them.

1. Prioritize your business needs and goals.

When negotiating an agreement, it is essential that you know why you want to enter this business transaction. You must know what you hope to gain by doing business with your proposed counter-party. Once you have established this to your satisfaction, make sure that you obtain what you can in order to achieve those goals.

2. Try to attempt to determine the risks in advance.

It is usually impossible to determine all the risks of a transaction before you start doing business. But it is possible to think of many of them. This is an area where the business-person, and not the lawyer, has most experience, and therefore should contribute most. The business-person should list the risk factors, and the client and lawyer should attempt to control for them in the agreement. To the extent that not all risks can be dealt with in the contract, the business-person should make the business decision as to whether the risks are worth taking for the greater good of the overall business to be gained.

3. Pay attention to "boilerplate."

All form contracts have "boilerplate," clauses such as governing law, place of dispute resolution, limitation of liabilities, etc. When negotiating with certain huge institutional companies such as Wal-Mart or banks, no amount of negotiation can get eliminate undesirable clauses from contracts. But that is really the exception to the norm. In most business transactions, the boilerplate, particularly clauses involving dispute resolution, warranties, hold-harmless agreements, and limitations of liability, may be negotiated. These clauses are usually the ones that, even in a well-drafted contract, cause grief if the business relationship goes bad. Pay attention to them, and try to eliminate the bad boilerplate and obtain favorable clauses instead.

4. Use a lawyer.

The overwhelming majority of business-people would prefer not to use lawyers in making business arrangements. While this is understandable, it does not make good business sense. A lawyer knows the local law and its peculiarities. In particular, in many instances, the lawyer knows the magic words that must go into a contract to secure the rights being negotiated. Every contract is dependent on such clauses (after all, that

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Practical Advice for Negotiating Agreements

is why there is "boilerplate"), and not using a lawyer – even if just to review a contract before signing – is a counter-productive strategy. The money spent on a lawyer will pay great dividends in the money saved by not having faulty contract provisions.

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Green Card for Investors

In the realm of different paths leading to permanent residence in the U.S., the EB-5 program, designed by U.S. Congress with stimulating economic activity and job growth in mind, allocates up to 10,000 immigrant visas each year to entrepreneurs (and their spouses and unmarried children under 21) who make an investment in a commercial enterprise in the U.S. and who plan to create or preserve 10 permanent full time jobs for qualified U.S. workers.

To be eligible, an investment of $1,000,000 or at least $500,000 in a targeted employment area (high unemployment or rural area) must be made into either a new or existing commercial enterprise. In return, the investor and his family receive conditional Green Cards for 2 years. Before the end of these 2 years, an application including evidence of the creation of the 10 jobs and proof the entire investment has been made is required in order to remove the conditions on permanent residence.

To encourage immigration through the EB-5 category, Congress created a Regional Center program for individuals who invest at least $500,000 to $1,000,000 in designated Regional Centers. The Regional Centers program does not require the immigrant investor enterprise itself to employ 10 U.S. workers. It is sufficient if 10 or more jobs are created indirectly as a result of the investment. A Regional Center is defined by any economic unit, public or private, engaged in the promotion of economic growth, improved regional productivity, job creation and increased domestic capital investment. Once Permanent Resident status is granted, minimal involvement with the investment is required, allowing the applicant to work in any business, go to school, or enjoy retirement.

For instance, the 5 boroughs of New York City qualify as a Regional Center for activities such as hotels, restaurants, retail stores or office buildings. The New York City Regional Center is an interesting alternative. It allows applicants to invest in real estate projects selected by NYC government agencies, economic development non-profits, and top real estate firms because they will create a significant number of new jobs. As most investment projects will be located in an approved targeted employment area, only a $500,000 investment is needed.

As the eligibility criteria for qualifying EB-5 investments are very strict, whether the investor directly invests in a new or existing business or through a regional center, interested applicants are advised to consult with qualified professionals beforehand. If you would like to learn more about this immigration benefit, 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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Requirement of a Spin Off

Code §355 is designed to permit tax free separation of one or more active businesses operated by corporation. It remains one of the only ways a corporation can avoid corporate tax on distributing appreciated property. A corporate division is accomplished when a parent corporation, distributes to its shareholders stock or securities of one of its controlled subsidiaries. A spin-off is a pro rata distribution of a controlled subsidiary stock by the distributing corporation to its shareholders.

Spin-Off Requirements

There are generally three different parties to a Code §355 spin-off distribution; the parent corporation who is distributing the subsidiary's stock, in our example it would be the German-GmbH; the corporation who stock is being distributed, in our example it would be the U.S. Corp; and finally the recipients of the U.S. Corp's stock, the shareholders who are in both U.S individuals and non-U.S. individuals with a majority being non-U.S individuals shareholders.

Five Statutory Requirements

1) *Control:* German-GmbH must have control of U.S. Corp. (368 (c))
2) *Active Trade or Business:* Immediately after the distribution, German-GmbH and U.S. Corp. each must be engaged in an active trade or business conducted for at least 5 years prior to the distribution.
3) *Device for E&P Distribution:* The transaction must not be used "principally as a device for the distribution of the earnings and profits of the German-GmbH or the U.S. Corp. or both".
4) *Acquisition of Control is the last 5 years:* German-GmbH must not have acquired control of U.S. Corp. within the preceding 5 years in a transaction in which gain or loss was recognized in whole or in part.
5) *Distribution:* German-GmbH must distribute either all of its U.S. Corp. stock or at least 80% of the stock and any stock retained was not to avoid U.S. Federal taxes.

Three non-statutory requirements

In addition, the Code §355 regulations impose certain non-statutory requirements:

1) *Business Purpose:* There must be a corporate business purpose for the separation of German-GmbH and U.S Corp. The business purpose requirement for Code § 355 requires a business purpose that could not be accomplished by any other reasonable non-taxable alternative.

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Aspects of Cross Border Reorganisations in US and German Tax Law

2) *Continuity of Shareholder Interest:* The predistribution German-GmbH shareholders must maintain adequate continuity in both German-GmbH and U.S. Corp. for some period of time following the distribution.
3) *Continuity of Business Enterprise:* There must be continuity of business enterprise by both German-GmbH and U.S. Corp. following the distribution.

Taxation of German GmbH

Where Code §355 applies, the German-GmbH group will not recognize gain or loss on the distribution of the stock of U.S. Corp., but recognize gain (but not loss) on the distribution of appreciated “other property” (i.e., boot). Since German-GmbH is not a controlled foreign corporation (greater than 50% of its shareholders are non-U.S. individuals), Code §367(b) does not apply. Therefore, there aren’t any additional international tax consequences.

Taxation of Shareholders

German-GmbH’s shareholders do not recognize taxable gain or loss or dividend income on the receipt of U.S. Corp. stock but are taxable on any boot received.
The U.S. shareholders will not recognize gain or loss or dividend income of the receipt of U.S. Corp. stock but are taxable on any boot received.

[1] Code §355(a)(1)(B). If German-GmbH distributes U.S. Corp. stock pro rata to its shareholders, who sell some or all of their stock for cash, these set of facts could be considered a device for E&P distribution and could jeopardize the tax-free nature of the spin-off.
[2] Code §367(e)(1) and Code §1248(f) do not apply because German-GmbH is not a U.S. domestic corporation.

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Latest U.S. Tax Legislation and IRS Guidance

Amongst currently pending U.S. tax legislation are the so-called "Extenders Bills" which are intended to extend provisions that expired at the end of 2009 so that they will become effective with retroactive effect in 2010 again. It is not unusual in U.S. tax law that provisions have an expiration date (mostly taxpayer friendly provisions with subsidy character) which needs to be explicitly extended or they otherwise expire. Currently the U.S. Senate is discussing a package including the extension of several important provisions that already expired at the end of 2009 (e.g. section 954(c)(6) IRC).

The latest version that was discussed in the Senate (now called "American Jobs and Closing Tax Loopholes Act of 2010") surprisingly includes several provisions that were added to the original bill as revenue offsets. Amongst these provisions there is a proposal to prevent foreign tax splitter structures and transactions in which the foreign tax is split from the underlying income, several additional foreign tax credit limitations and a changed treatment of so-called section 304 transactions (characterization of capital gains as a dividend) in certain structures. In addition the so-called section 861 80/20 rules would be repealed for tax years beginning after December 31, 2010. Under the mentioned 80/20 rule, dividends and interest paid by a domestic corporation with at least 80% foreign source gross income are treated as foreign source. Accordingly, they are not subject to withholding and could be treated as foreign-source income for purposes of the foreign tax credit.

In order to deal with the blockade of the described package by the U.S. Senate the House Committee just recently introduced a new law proposal (called "Investing in American Jobs and Closing Tax Loopholes Act of 2010") that changes the effective dates of the old proposals and does not include an extension of several provisions any longer. As these proposals could have a significant impact in international structures further developments should be closely monitored.

The IRS and the Treasury Department issued final partnership regulations on June 8 with regard to the application of anti-abuse regulations for contributed property under section 704(c). The final regulations were adopted as proposed by the IRS in 2008 and deal with the allocation of income, gain, loss or deductions to the partners in a partnership. In case such an allocation may satisfy the literal language of the rules but is not reasonable as the allocation is made with a view to shift the tax consequences between the partners the IRS can recast the allocation to a certain extent as deemed to be appropriate.

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S Corporations with Losses and Related Party Loans

Occasionally, a resident alien or green card holder will have an interest in an S corporation (not an option for a nonresident alien). If the corporation has losses, a shareholder in such a company will need basis to be able to deduct the losses on his tax return. Assume the shareholder has another US business with profits and cash flow, and the shareholder decides to use this business, e.g., a partnership as a funding vehicle to create basis in the S corporation. He does this by borrowing money from the partnership and then loaning that same money to the S corporation, thereby creating basis for purposes of deducting losses. The S corporation in turn pays rent to the partnership for property it leases. Note documents were created, interest was charged on some of the notes, and one partial repayment of principal was made. Problem solved, right?

Not exactly. The above facts come from the Kerzner v. Comr. case, TC Memo 2009-76, a case decided against the taxpayers, i.e., the loans did not create basis and their loss deductions were disallowed. In fact, the above transaction structure didn't even rise to the level of back-to-back loans, where taxpayers have had some success. Instead the Court held that there was no economic outlay, only a circular flow of funds.

In the above case, there was only paper debt. In some other cases, In Culnen v. Comr., T.C. Memo 2000-139, proceeds of a loan to shareholder were paid directly from one corporation to the second. The taxpayer's evidence showed that the loan obligated the shareholder, including bookkeeping entries and witnesses as to his intent. On the other hand, in Oren v. Comr., T.C. Memo 2002-172, the Court found that the transactions were simply "offsetting bookkeeping entries". The funds went to the shareholder, then from the shareholder to the second corporation and back to the first corporation, with the Court not convinced that an economic outlay had taken place, and consequently disallowing losses.

The moral of the above, is that when structuring loans between related parties, it pays to do so in a way that shows that the shareholder has some economic outlay and risk of loss. This is especially relevant when trying to create basis which will allow a net operating loss carry back at the shareholder level, particularly if the year to which the loss is being carried back is a high tax year that will be lost for carry back purposes.

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New York Tax Resident vs. Non-resident Status Avoiding a Surprise!

German nationals coming to work in the U.S. face many complex tax issues. Not only are there many first year choices available relating to federal taxation, most states in the U.S. impose a tax as well. Also, individuals considered to be tax-resident in New York City ("NYC") are subject to NYC tax in addition to New York State ("NYS") tax. This discussion focuses on taxation of individuals in NYS and NYC and examines the NYS laws regarding residency status. A finding that an individual is tax non-resident can lead to significant savings.

One reason why non-residential status is more favorable for tax purposes is that NYS residents are taxed on their worldwide income, while non-residents are subject to tax only on income that is considered to be from NYS sources. Another tax savings for taxpayers considered to be nonresident is that they will not have to pay NYC income taxes, even if they work in NYC. (However, this wage income will be subject to NYS tax since it is sourced to NYS.)

The NYS rules regarding residency are based around the concept of "domicile". Domicile is defined as "the place you intend to have as your permanent home". The NYS Department of Taxation further refers to domicile as "the place you intend to return to after being away". An important aspect of the domicile concept is that an individual can have only ONE domicile. Many German nationals in the U.S. on business intend to return to Germany and can be considered non-domiciliaries for NYS tax purposes. Under §605(b)(1) of the NYS tax law, if your domicile is outside of NYS you are considered a non-resident unless you "maintain a permanent place of abode in NYS for more than 11 months of the year and spend 184 days or more in NYS". An apartment or house in NYS would constitute a permanent place of abode so this requirement is easily met. However, foreign nationals can avoid residency if they keep the number of days spent in NYS to 183 or less, OR if they did not live in NYS for more than 11 months in the year. Foreign nationals can often use "the 11 month rule" to avoid residency in the year they arrive in NYS and in the year of departure.

For those German nationals who decide to stay and make NYS their domicile, residency can be avoided if they have a permanent home outside the State, no "permanent place of abode" in NYS, and they spend less than 30 days in NYS. A further exception to residency exists for certain taxpayers who are present in a foreign country for a consecutive period of 548 days and who meet certain other requirements.

The above rules illustrate the complexity of the NYS tax rules. Given that the NYS and NYC combined tax rates can be greater than 10%, taxpayers with significant non-NYS source income should claim non-residency status if their factual situation can support this claim. Where possible, advance planning could be critical.

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German Flat Rate does not override Tax Treaty

Until the end of 2008, gains derived from many forms of investment were exempt from tax if the German taxpayer had held those investments for longer than a year. For dividends the so-called “Halbeinkünfte-Verfahren” was applied so that only 50% of the dividends were subject to tax at the average income tax rate of the taxpayer.

These special rules have changed drastically for the tax year 2009. For many investment forms those rules were replaced by a flat tax of 25% regardless of the holding period. A withholding tax (25% + Solidarity Surcharge + Church Tax) is deducted automatically from the distribution if the beneficial owner is a resident of Germany. In addition, the withholding tax will be a final tax, unless the recipient of the dividend applies for taxation of his/her dividend income at his/her individual income tax rate.

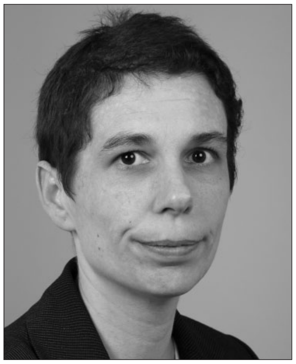
The US-German tax treaty provides that dividends paid by a company that is a resident of Germany to a resident of the US may be taxed in the US and vice versa. However, Article 10 of the tax treaty allows Germany (respectively the US) to tax those dividends as well, provided the tax does not exceed

1. 5% of the gross amount of the dividends if the beneficial owner is a company that holds directly at least 10% of the voting shares of the company paying the dividends, or
2. 15% of the gross amount of the dividends in all other cases

Interest income derived from Germany and beneficially owned by a resident of the US shall be taxable only in the US and vice versa. Interest in this context is defined as income from debt claims of every kind as well as income treated as income from money lent as defined in the tax law of the State in which the income arises.

The taxpayer is obligated to inform the withholding financial institution about his/her residency status. If a US resident individual receives dividends from a German company and/or interest income from a German financial institution, withholding should be limited to 15% and 0% respectively rather than 25 percent. The German withholding tax on dividends at the treaty rate can be credited against the tax liability of the US resident on his/her US income tax return. US Tax Form 1116 calculates the appropriate amount of Foreign Tax Credit (FTC) applied to offset the tax liability in the US. Amounts not used for the current tax year can be carried back one year and forward ten tax years.

Note: The implementation of the “Abgeltungssteuer” in the form of a flat rate (final tax) does not override the provisions of the US-German tax treaty.



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U.S. Tax Due Diligence – Recent Changes to Statute of Limitations Provision

Even though the current transaction market in the United States is significantly slower than during its 2006 / 2007 peak period, decreased assets values, a weakened dollar and the attractiveness of US companies to non-US buyers have booted and spurred the volume of U.S. "inbound" deals. Potential investors start their due diligence early in the deal process and given the multiple tax challenges involved in cross-border transactions, tax risks inherent in the target company and its subsidiaries are an important factor in the sale and purchase negotiations and from a risk management perspective. A recent legislative change with respect to U.S. international tax forms may suspend the statute of limitations for U.S. tax returns. Potential investors in U.S. target companies need to be aware of this change to appropriately scope their tax due diligence and negotiate indemnity provisions in sale and purchase agreements.

For U.S. target companies with multinational operations, the Hiring Incentives to Restore Employment (HIRE) Act (P.L. 111-147), enacted on March 18, 2010, contains a significant change with respect to the filing of international information reporting returns in amended Internal Revenue Code Section 6501(c)(8). According to the amended provision, the non-filing, incomplete or even incorrect filing of certain informational returns can result in a suspension of the statute of limitations for a taxpayer's entire return. The amendment applies to tax returns filed after March 18, 2010 and to returns filed before that date if the statue of limitations period for that return is still open.

Information returns affected by the modified provisions are – inter alia – Form 926 ("Return of a U.S. Transferor of Property to a Foreign Corporation"), Form 5471 ("Information Return of U.S. Persons With Respect to Certain Foreign Corporations"), Form 8858 ("Information Return of U.S. Persons with Respect to Foreign Disregarded Entities"), Form 8621 ("Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund") and Form 8865 ("Return of U.S. Persons With Respect to Certain Foreign Partnerships").

Even though it is not entirely clear under which circumstances the IRS may consider an incorrect return "substantially incomplete", it appears that inadvertent omissions of international forms, such as Form 5471 for a dormant entity or the use of IFRS instead of U.S. GAAP numbers on a form could result in a suspension of the statute of limitations for the entire U.S. tax return. The original language of IRC Section 6501(c)(8) does not include a reasonable cause exception for the statute suspension. However, such language is included in the tax extenders package, which is in discussion at the time of writing this article.

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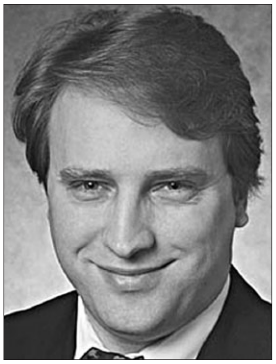
U.S. Tax Due Diligence – Recent Changes to Statute of Limitations Provision

Ernst & Young has a dedicated team of professionals to address the issues and goals of companies engaging in cross-border transactions. If you would like to get more information or have any questions, please feel free to contact us.

[1] In general, the statute of limitations for auditing of a tax return is three years, and ten years for collection of tax. If the taxpayer omits additional gross income in excess of 25% of the amount of gross income stated on the tax return, the statute is extended to six years.

[2] There are additional, less common forms that fall into the scope of amended IRC Section 6501(c)(8).



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Managing Disputes Between German and U.S. Parties: Proper Planning is Half the Battle

The high volume of commercial transactions between Germany and the United States brings with it a corresponding number of disputes. Given that there is no supra-national court for such commercial cross-border litigation, either German or U.S. courts – or both – are the only recourse. The mutual disapproval or resentment towards each other's judicial system goes beyond "home court advantage" and is deeply rooted in the fundamental differences between the German (civil law) and the U.S. (common law) systems.

For Germans, standard U.S. procedures of notice pleading, jury verdicts, punitive damages, and pre-trial discovery (especially depositions) are hard to understand. Conversely, Americans cannot fathom how they could be expected to fully brief their case supported by all the evidence in the first pleading, why a German court would consider hearsay evidence but not cross-examine witnesses, or why the losing party should bear the costs. The current lack of a treaty for the reciprocal recognition and enforcement of judgments does not help. The Hague Choice of Court Convention, if ratified, may change this.

One viable solution is arbitration – which is a creature of contract: No arbitration agreement, no arbitration. A valid, enforceable and effective arbitral clause needs to do three things:

- define the scope of covered disputes,
- make arbitration mandatory, and
- select the governing rules.

The arbitration may be administered by one of the many arbitral institutions such as the German Institution of Arbitration [DIS], the International Chamber of Commerce [ICC], or the International Centre for Dispute Resolution [ICDR], or by the parties themselves. Institutional arbitration is usually the safer choice, as it provides a tested set of rules. All arbitral institutions have model clauses. Recommended additional provisions include

- the place of arbitration (which has significant legal implications),
- the governing substantive law,
- the language of the arbitration,
- the number of arbitrators and the method of their selection.

The parties may further

- require specific qualifications or nationalities of the arbitrator(s),
- set forth the extent of document disclosure,
- provide for confidentiality,
- deal with costs and fees.

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CHADBOURNE & PARKE LLP

The Foreign Manufacturers Legal Accountability Act: Made in Germany – At Risk in U.S.A.?

Special issues arise when multiple contracts and/or parties are involved. Negotiation or mediation before arbitration may be mandated. In construction contracts, dispute boards may be set up.

There is no "one size fits all" solution. A specialist should be involved in the contract drafting early on – not at the last minute. The careful drafting of an arbitration clause can save years of litigation and potentially millions of dollars in related costs.

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