PKF DEUTSCHLAND

Newsletter 06 | 24

Key Issue

Sustainability reporting – A step-by-step guide
Part IV – ESRS on environmental aspects

Dear Readers,

In the light of a recent Federal Fiscal Court ruling, we kick off the June edition of our newsletter with a clarification of the conditions under which the costs of a **company event** that not all the employees had attended would be tax deductible.

In our second report in the Tax section, we discuss two specific **transfer pricing rules** on **cross-border group financing** that were introduced via the German Growth Opportunities Act. The issue that is subsequently discussed is also of an international nature, namely, tax equalisation and tax protection in the new **'183-day circular' on working abroad.**

Our Key Issue report can be found in the Accounting & Finance section where, in the next article in our series on **sustainability reporting**, we have now come to the ten topical ESRS standards for the environmental, social and governance (ESG) reporting categories. In this issue of our newsletter, we discuss the most important aspects of the **five environmental standards**.

Next up, we have a clarification, based on a new Federal Fiscal Court ruling, of the accounting treatment of the **purchase of receivables at below their nominal value in the case of restructuring.**

In the report that then follows, we once again focus on the topic of the opportunities and risks of **artificial intelligence (AI)** as we specifically consider the use of AI in **M&A transactions** generally and particularly in the **due diligence process**.

Then, through the illustrations that break up the reports from our experts, in this edition we visit our PKF colleagues in Belgium.

We hope that you will find the information in this edition to be interesting.

Your Team at PKF

. EU Commission buildings in Brussels

Front cover photo: The Atomium in Brussels

Key Issue

Sustainability reporting - ESRS on environmental aspects

Contents

StBin [German tax consultant] Patricia Breit

Tax treatment of company events

Staff and management can get together for the annual company outing, the Christmas party or also an anniversary celebration outside of work in a relaxed and jolly atmosphere. The costs of such company events are, in most cases, not insignificant and therefore repeatedly the focus of tax auditors. Here, disputes can arise in relation to the treatment of the business expenses that have been recognised in terms of income tax, payroll tax and VAT.

1. Definitions

A company event is one where the group of participants consists mainly of company employees and possibly their accompanying guests (spouses or life partners). By contrast, company events do not include celebrations for individual employees or business dinners.

The taxation of employee benefits within the scope of company events is regulated in Section 19(1) no. 1a of the German Income Tax Act (Einkommensteuergesetz, EStG).

If the costs per employee and per company event do not exceed the amount of € 110 then they would not constitute taxable remuneration. The amount here should be understood to include value added tax. In terms of the number of company events, two events per year would be considered to be reasonable.

For income tax purposes the €110 rule constitutes

Brabo Fountain in Antwerp

a tax-free amount, however, for VAT purposes the amount is classified as a tax exemption threshold.

2. Classification for income tax purposes

2.1 Allocation of costs

The employer's costs have to be apportioned among all those participants who were present at the company event. The number of people who were invited is not important. Subsequently, the share of the costs allocated to accompanying guests has to be attributed to the respective employees. No additional tax-free amount of €110 may be recognised for an accompanying guest.

Example: The costs for a company event are €10,000. The participants consist of 75 employees and 25 accompanying guests. In this case, the costs have to be distributed between 100 people so that a benefit-in-kind worth €100 is apportioned to each person. The benefit-in-kind apportioned to an accompanying guest has to be attributed to the respective employees:

- 50 employees come without an accompanying guest; they have a benefit-in-kind worth €100, which does not exceed the tax-free amount of €110 and is therefore not taxable.
- For each of the 25 employees with accompanying guests the benefit-in-kind is worth €200; after deducting the tax-free amount of €110 the taxable benefit-in-kind for each of these employees amounts to €90.

2.2 Payroll accounting

Benefits-in-kind generally have to be taxed via the payroll. In practice, employers frequently assume the tax burden so that the employees do not have to bear any financial consequences as a result of participating in a company event. The payroll tax can be levied at a flat rate of 25% (a separate application does not need to be filed with the local tax office). This flat-rate taxation would be permissible even if few employees were affected. In addition to the flat-rate payroll tax, the solidarity surcharge at 5.5% and, if applicable, church tax at a flat rate would also be incurred. Due to the flat-rate payroll tax the mandatory social security contributions will not apply.

A recent Federal Fiscal Court (Bundesfinanzhof, BFH) ruling of 27.3.2024 (case reference: VI R 5/22) included a discussion of whether flat-rate taxation may be used if not all employees had been given the option of participating in an event, or whether the total employee benefit should be treated as remuneration that is subject to mandatory tax and social security deductions. The BFH judges were of the opinion that even in such a case flat-rate taxation could take place. The legal definition of a company event merely requires it to be at the company level and to be of a social nature and not that all the company employees have to be invited.

Please note: Non-cash benefits (gifts for employees) would not be a part of remuneration if they were presented during a company party (already according to a Federal Ministry of Finance circular of 14.10.2015). Such benefits are classified as being part of the costs of the company party and, accordingly, have to be offset against the tax-free amount of €110.

2.3 Business expense deduction

The costs for the company event as well as the flat-rate payroll tax can be deducted as business expenses even if the tax-free amount has been exceeded.

3. VAT treatment

If the per employee amount for the company event exceeds €110 (where applicable, including the share of the costs for each accompanying guest) then none of the input tax for the costs may be deducted. According to the BFH ruling of 10.5.2023 (case reference: V R 16/21), boosting employee motivation and enhancing the workplace atmosphere has to be classified as being for private reasons. However, for an input tax deduction there has to be a direct and immediate link between the input and output transactions.

Recommendations

Keep a close eye on the option of flat-rate payroll tax, in particular, if there are more than two company events per year. Prior to any event it would make sense to get a detailed calculation of the costs in case they are close to the limit of the tax-free amount per employee. Beyond the tax aspects, the focus should nevertheless be on fostering the atmosphere and togetherness.

PKF

WP/StB [German public auditor /tax consultant] Dr Dietrich Jacobs

Transfer pricing rules for financing transactions

Through the Growth Opportunities Act (cf. PKF newsletter 3/2024) the German tax legislator introduced two specific transfer pricing rules on the treatment of financing transactions (Section 1(3d) and (3e) of the Foreign Transactions Tax Act [Außensteuergesetz, AStG]), which came into effect in 2024 for the first time.

1. Inbound financing relationships

1.1 New legislation on the deduction of expenses

Under the new legislation, it would not be consistent with the arm's length principle if an expense arising from an intragroup cross-border financing relationship had reduced the taxpayer's (German) income and, in addition:

(1) the taxpayer could not credibly demonstrate that they (a) would have been able to service the debt over the entire term of the financing relationship from the outset **(debt capacity)** and that they (b) need the financing and used it for the corporate purpose **(need for the financing)**; or

(2) the extent to which the interest rate payable exceeds the interest rate at which the company could obtain financing on the basis of the **corporate group rating** (here this should be understood to mean the rating of the head of the group). If proof is provided that an individual rating derived from the corporate group rating complies with the arm's length principle then this individual rating would be decisive.

From 2024, fully claiming expenses for inbound financing relationships will be restricted even for already pre-existing financing relationships.

Please note: If debt capacity cannot be credibly demonstrated then, according to the wording of the legislation, it is to be feared that the tax deduction of expenses will be denied outright.

In the future, insofar as the aim will generally be to use the corporate group rating as a basis, then in a typical situation where the foreign head of the group enjoys better ratings than when making a sole comparison with the German subsidiary the following effect will ensue: the German lawmaker will ultimately assume that there is (full) implicit group support from the foreign head of the group for the German borrowing subsidiary so that the lawmaker will accept only interest rates that are lower than would be the case in a standalone situation for the German subsidiary; by contrast, if only limited support or even none at all could be expected from the head of the group in the event of the borrowing company entering into a crisis then the German subsidiary would have to provide proof of this and then derive its own applicable standalone rating from the corporate group rating.

Please note: When compared with the previous legal situation, the burden of work and of proof has thus effectively been reversed because, in the opinion of the Federal Fiscal Court (ruling of 18.5.2021, case reference: I R 4/17), up to now, the borrower's standalone rating frequently had to be primarily used.

1.2 Recommendations

For inbound financing relationships the following recommendations for action can be inferred:

» from 2024, if transfer pricing related restrictions on the recognition of expenses for inbound financing relationships are to be avoided then the new legal provisions will also have to be complied with in the case of pre-existing intragroup financing relationships.

» If a debt capacity forecast was not already prepared when the respective financing relationship commenced then such a forecast should be prepared, without further delay, on the basis of the circumstances and knowledge at that time (cut-off date principle).

» It likewise has to be credibly demonstrated that the financing is needed and that it will be used in accordance with the corporate purpose. These requirements should be met not just at the start of a financing relationship; rather, evaluations also need to be made with respect to, for example, the extent to which excess liquidity generated during

the term of the loan should be used for repayment purposes.

» Ultimately, if a taxpayer in Germany wants to deviate from the corporate group rating then an increased workload will be imposed on them in two respects: firstly, they would have to determine the corporate group rating and, subsequently, from this derive the borrower's individual rating. By contrast, according to the wording of the legislation, it would not be possible to 'freely'/directly determine the individual rating. Furthermore, it would however be necessary to provide proof that in the actual individual case it is not the corporate group rating but rather the individual rating that complies with the arm's length principle.

2. Referring or brokering of financial relationships, treasury and financing companies

2.1 New legislation on low-function and low-risk services

Under the legislation, if on the basis of a functional and risk analysis no evidence to the contrary is provided, then a low-function and low-risk service will normally be deemed to exist if

» a financing relationship between one company and another group company is brokered or is referred, or
» if a company in the group of companies assumes the management of funds or acts as a financing company for one or more group companies.

Please note: This provision will thus affect, for example, cash pools, treasury and financing companies.

In the case of low-function and low-risk routine services the appropriate transfer prices are frequently determined on the basis of the cost-plus method. In such cases, it is likely that in the future there will be no more discussions with the fiscal administration about the correct transfer pricing method.

2.2 Recommendations

The following action points should be taken into account:

» From 2024, this rule likewise applies, without any transitional arrangements, to business relationships that had already been previously agreed.

La Grand-Place in Brussels

There should therefore be a review of the extent to which any necessary redetermination of the reasonable charges is appropriate.

» Insofar as the taxpayer does not manage the above-mentioned business relationships as routine services then, from 2024 at the very latest, great importance will be attributed to the detailed proof of the functions performed, the risks assumed and the assets employed. In such cases, it would therefore often be advisable to focus attention on a precise and full analysis of the facts and circumstances and their documentation.

Working abroad - Tax equalisation and tax protection in the new '183-day circular'

During a period of working abroad, employers and employees normally conclude tax equalisation agreements. The usual methods here are tax equalisation and tax protection. One of the tax equalisation methods that underlies the posting of employees will ensue from the employer's general posting guideline. In addition, individually applicable arrangements under the contract of employment have to be taken into account.

In this connection, the Federal Ministry of Finance (Bundesministerium der Finanzen, BMF) recently compiled the principles that have to be observed in a circular of 12.12.2023 (reference: IV B 2 - S 1300/21/10024 :005).

1. Alternative methods

In the case of tax equalisation, employees should be made liable to taxation in the amount equivalent to the one that would have to have been paid if they had remained in their home countries irrespective of the tax rates applicable in the host state. By contrast, in the case of tax protection, employers only compensate the tax disadvantages in the host country. Accordingly, an employer would assume the additional tax charges in the event that the taxes in the host state are higher than those in the home country. However, if the tax rate in the host country is lower than in the home country then the benefit would go not to the employer but instead to the employee.

2. Hypothetical tax withholding and actual tax payments

Both methods can result in hypothetical tax (hypotax) being withheld from employees within the scope of salary accounting. In return, employers assume the actual taxes that are incurred (in the host state). Hypotax does not constitute the tax that is actually paid in the home country or host state, but rather a fictitiously calculated quantity within the scope of the internal relationship between the employee and employer. Hypotax reduces an employee's gross salary. If an employer withholds a hypotax then this would be a salary deduction and the employee would not receive the equivalent amount as salary.

Please note: The full amount of income tax that has actually been paid by the employer for the employee has to be classified as the employee's salary in the respective state (state of domicile or the state where the work was performed) where it was incurred.

3. Special features of net pay agreements

In cases where employees work across borders, it is first necessary to check whether gross pay agreements or net pay agreements have been made. Under a net pay agreement, the employer pays the employee a fixed net salary. The employer likewise undertakes to bear the cost of all or specific levies (tax and social security contributions) for the employee.

If a domestic (German) employer pays a net salary then this value has to be 'grossed up' for the respective remuneration payment period. If the employer assumes the responsibility for making the employee's additional income tax payments, then, on the date of the payment, this would result in a further inflow of remuneration for the employee that would, in turn, have to be 'grossed up'. Adding together the grossed-up salaries for the individual remuneration payment periods (consisting of regular salary payments and other compensation) results in the employee's total grossed-up annual salary. This grossed-up amount should be shown on the electronic certificate of payroll tax deductions as taxable gross salary or as the employee's

tax-free salary under a double taxation agreement.

If the employer is not obliged to deduct payroll tax in Germany and the salary payment to the employee is made on the basis of a net pay agreement then, in the assessment, only the net salary that was paid out in the respective calendar year has to be included. It is only when the foreign employer subsequently compensates the accrued tax amounts that this compensated amount has to be taxed once again within the scope of the income tax assessment. In these cases, the amount is not grossed up.

4. Financial support for prepayments

If, in exceptional cases, an employee receives financial support from the employer during the calendar year already so that the employee is able to make the prepayments that become due to the tax office then, to this extent, this would also constitute remuneration that had already accrued. The same would apply if the employer were to transfer the prepayments directly to the tax authority responsible for the employee's assessment. Here, too, the amount would not need to be grossed up.

ACCOUNTING & FINANCE

WP [German public auditor] Alexander Paul / Dennis Schöttinger

Sustainability reporting – A step-by-step guide

Part IV – ESRS on environmental aspects

The ecological sustainability dimension is at the core of the EU's Taxonomy Regulation and a fundamental part of the mandatory reporting standards (ESRS) and thus highly important in the context of sustainability reporting. In the last issue of our newsletter, we focused on the EU Taxonomy; now, this fourth article in our series on sustainability reporting is devoted to the environmental ESRS.

1. ESRS E – An overview

The first set of ESRS includes twelve standards, of which two are cross-cutting standards and ten are topical standards (cf. PKF Newsletter 03/24). The topical standards – thereof five on environmental aspects, four on social aspects and one on governance aspects – cover the three sustainability

Regatta on a North Sea beach

dimensions and are each divided into so-called 'topics', 'sub-topics' and, in some cases, 'sub-sub-topics'. The environmental standards (ESRS E, where 'E' stands for environmental) include:

- **ESRS E1** – Climate change
- **ESRS E2** – Pollution
- **ESRS E3** – Water and marine resources
- **ESRS E4** – Biodiversity and ecosystems
- **ESRS E5** – Resource use and circular economy

Despite the thematic demarcation between the individual standards, nevertheless there are overlaps in terms of content. The sub-topics of ESRS E1 are, for example, climate change adaptation, climate change mitigation and energy. ESRS E4 is divided into, among others, the sub-topics of impacts on the state of species or direct impact drivers of biodiversity loss where, in turn, sub-sub topics, such as climate change or pollution are of significance here.

2. Scope of the reporting

ESRS 2 (general disclosures) has to be taken into account by all the entities that are subject to the reporting obligation; however, the application of the topical standards will depend on a materiality assessment (cf. PKF newsletter 4/24). Consequently, topic-related standards may wholly or partially (e.g., certain sub-topics) not be subject to the reporting obligation. If a particular ESRS is completely omitted then according to ESRS 2, in the section IRO-2, there is a recommendation to provide a specific explanation as to why the topic was considered to be immaterial in its entirety. In this respect, ESRS E1 (climate change) is a special case. If ESRS E1 is categorised as being an immaterial issue then, besides the conclusions from the assessment of the materiality, a prospective analysis has to be provided of the conditions that, in the future, could yet lead the company to view climate change as a material issue.

3. Structure of the standards and disclosure requirements

The environmental ESRS (= ESRS E) are similarly structured and, in each case, begin with an overview of the objective of the standard, its interactions with other ESRS and the relevant disclosure requirements that result from ESRS 2. The ESRS E differ, in particular, in respect of the number of disclosure requirements, which are assigned to specific reporting areas in each case.

Reporting areas
Governance (**GOV**)
Strategy and business model (**SBM**)
Impact, risk and opportunity management (**IRO**)
Metrics and targets (**MT**)

According to all the ESRS E there has to be reporting on, among other things, the process to identify and assess the materiality of the impacts, risks and opportunities for the respective topics as well as on their potential financial effects. The extent to which a company's sustainability-related performance is integrated into its incentive schemes is however, for example, only relevant for ESRS E1 (ESRS 2 section GOV-3).

4. An insight into ESRS E2 on pollution

The ESRS E2 addresses the disclosure requirements for the topic of pollution and covers seven sub-topics that include, for example, the pollution of air, water and soil (ESRS E2-4). In Table 1, by way of an example, we have presented the individual disclosure requirements for ESRS E2.

In the course of a materiality assessment of environmental sub-topics, a company would assess from the perspective of the stakeholders whether or not the pollution in its own operations and in its upstream and downstream value chains (ESRS 2 IRO-1) is material. Here, the ESRS recommend a specific approach according to which companies are first (1) localised, (2) evaluated and then (3) assessed with regard to the opportunities and risks (ESRS E2 AR1):

- In the course of localisation, it will be relevant to ascertain where the company interfaces with nature (e.g., at its operating facilities where emissions of water, soil and air pollutants (could) occur).
- In a second step, the impacts and dependencies will be evaluated for each site or sector/business unit whereby the severity and likelihood of the impacts on the environment and human health will be of relevance.
- On the basis of these two steps, an assessment of the risks and opportunities will then be made. In doing so, opportunities can also be determined that are related to pollution prevention and reduction. A company could benefit, for example, if through environmentally sustainable

Table 1: Disclosure requirements under ESRS E2		
Reporting area	**ESRS**	**Contents**
Management of the impacts, risks and opportunities (IRO)	ESRS 2 IRO-1	Description of process to identify and assess the material impacts, risks and opportunities related to pollution
	ESRS E2-1	Strategies related to pollution
	ESRS E2-2	Actions and resources related to pollution
Metrics and targets (MT)	ESRS E 2-3	Targets related to pollution
	ESRS E 2-4	Pollution of air, water and soil
	ESRS E2-5	Substances of concern and substances of very high concern
	ESRS E2-6	Potential financial effects from impacts, risks and opportunities related to pollution

production processes it could obtain access to green funds, bonds and loans.

Furthermore, according to ESRS E2-1, a company has to describe the strategy related to pollution prevention and reduction that it will deploy. The description has to contain, among other things, information about the pollutants that are included and may be integrated into cross-thematic comprehensive environmental and sustainability strategies (e.g., with regard to crop protection).

Example: In this regard, here is a practical example from the BASF chemicals group: "BASF adheres to the International Code of Conduct issued by the World Health Organization (WHO) and the Food and Agriculture Organization (FAO) for the marketing of crop protection products. These are only marketed once they have been approved by the competent authorities. We no longer sell WHO Class 1A or 1B products (high acute oral and dermal toxicity), even if formal approvals exist." (BASF SE, BASF Report 2023, p. 150)

The disclosure requirements of ESRS E2-2 address the subsequent actions taken and planned in order to achieve the objectives and targets of the strategy in the context of pollution. These include, for example, reducing or preventing the use of harmful or unsustainable substances in the production process; moreover, using recycled building materials in the construction sector or forgoing plastic packaging would also be possible.

Disclosure requirements in the metrics and targets category are contained in ESRS E2-4, which stipulates that the substances a company emits through its own activities have to be disclosed. Information about which ones contain, for example, ozone-depleting substances or nitrogen oxides generally has to be provided at the level of the reporting company, however, this data may also be broken down.

Please note: In addition to the standards, EFRAG (European Financial Reporting Advisory Group) has published a detailed overview of all the datapoints of the ESRS. This overview together with implementation guidance for the materiality assessment and the analysis of the value chain are available on the EFRAG website.

Takeaways

- The ESRS E address five subject areas and show their interdependencies in terms of content.
- ESRS E1 (climate change) stands out with respect to the depth of detail and the scope of the disclosure requirements.
- The ESRS disclosure requirements have to be met while taking into account the differences in the various reporting areas.
- EFRAG has made available comprehensive implementation guidance on the ESRS.

Accounting treatment of the purchase of receivables at below their nominal value in the case of restructuring

If a partner has purchased a receivable against the company at below its nominal value and subsequently waives their claim to the portion of the amount of the receivable that exceeded the purchase price then the resulting reduction in the liability for the company would give rise to a 'cancellation gain'. Neutralising this gain via a tax adjustment item is not possible. This was the conclusion arrived at recently by the Federal Fiscal Court (Bundesfinanzhof, BFH) and it was in contradiction with the view of the lower court.

1. Recognition in the special-purpose balance sheet and income realisation in the joint ownership sphere

Generally, for transactions between a company and partners the correspondence principle will be largely applicable; therefore, assets have to be uniformly recognised in the company's balance sheet for jointly owned assets and in the partners' special-purpose balance sheets. However, the acquisition cost principle takes precedence over the correspondence principle. If the purchase price of a receivable was below its nominal value, then the amount that could be recognised in a special-purpose balance sheet would be restricted to the lower purchase value. For the duration of the relationship with the company, the partner would generally not be able to adjust the value of their receivable, but would instead postpone the loss incurred in the special-purpose sphere to a time when the co-entrepreneurship is terminated or the partner has resigned.

Please note: Nevertheless, according to the BFH, this would not preclude income realisation in the joint ownership sphere. This was the decision of the court in the case where a partner purchases a receivable against the company at below its nominal value and waives the claim to the portion of the amount of the receivable that exceeds its purchase price.

2. New BHF ruling on agreements on profit participation rights and their acquisition below value

The BFH, in its ruling of 16.11.2023 (case reference: IV R 28/20) decided on a case where a GmbH & Co. KG [a German limited partnership with a limited liability company as a general partner] had concluded agreements with its creditors on profit participation rights in the amount of €28m. The company recognised the liabilities resulting from these agreements at their nominal value in the balance sheet for jointly owned assets. After the KG got into financial difficulties, the partners purchased the profit participation claims for €14m and, immediately after their purchase, waived their claim to the value that exceeded their purchase price. The waiver had been a condition of the external providers of capital for providing further financing. The KG assessed the waiver by the partners in relation to the profit participation claims they had purchased as not having to be recognised as income for tax purposes. That was why in the tax accounts they neutralised the income shown in the financial accounts from the cancellation of the liabilities via a tax adjustment item.

However, following an external tax audit, the local tax office was of the view that the transactions had resulted in income realisation in the amount of €14m at the KG. The KG refused to accept this and, initially, was successful before the Rhineland-Palatinate tax court. However, the BFH rejected this and ruled that the principle of corresponding accounting did not preclude the recognition of income from the derecognition of the liabilities.

3. Outcome

In the specialist literature some argue that the principles of the BFH's Large Senate on the tax treatment of the waiver of receivables by a shareholder of a corporation should be correspondingly applicable. Accordingly, the portion of the receivable that is still recoverable would be viewed as a contribution for the corporation and a withdrawal for the shareholder. The amount of the non-recoverable portion of the receivable would give rise to income for the corporation and a deductible expense for the shareholder. The BFH has now, at least in the case in question, rejected this particular interpretation.

Benedikt Imbusch

Artificial intelligence in M&A transactions – Impacts on the due diligence process

Artificial intelligence (AI) is also increasingly being used in corporate transactions. In the following section we discuss the possible uses, opportunities and risks in the due diligence process.

1. Expectations

The M&A industry is on the verge of a revolution – the use of AI could radically change the due diligence process. In the past, very many human resources were needed for data analysis. However, highly efficient AI algorithms could help to process large volumes of data in the shortest time.

By using AI in the context of due diligence, consultants will be able to identify potential risks and opportunities more quickly and precisely. AI systems can provide support for comprehensive analyses as well as for reviewing contracts and legal requirements. As a result, the efficiency of the due diligence will be enhanced.

Please note: Despite all the advantages there are nevertheless challenges and potential risks associated with the use of AI in due diligence. It is important to understand these and to put appropriate arrangements into place in order to still be able to ensure both the integrity and confidentiality of the data as well as the quality of the advice.

2. Fields of application for the buy side and the sell side

Virtual data rooms constitute a basic technology for the application of AI in due diligence processes. A virtual data room is where documents and data are made available by the sell side to the buy side.

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Possible uses	Application field
Data analysis	Description of the process for determining and assessing the major impacts, risks and opportunities related to pollution.
Identifying risks and opportunities	Potential risks and opportunities in the analysed data can be identified early on by, for example, comparing these with market data.
Analysing documents	Contractual documents (rental agreements, customer and supplier agreements, etc.) can be automatically analysed and important information (such as, e.g., change of control clauses) can be selected. This saves time and minimises the risk of overlooking these.
Pattern recognition	Patterns and relationships in the analysed data can be identified and is something that is very complicated and difficult when using traditional methods.
Consultants' focus	Greater concentration on the relevant aspects due to AI taking over routine activities. As a result of the time saved on carrying out laborious tasks, consultants can focus even more on those aspects that require a lot of experience and human expertise.

Table 2: Summary of the opportunities for the use of AI algorithms

If AI or a data analysis function is included in these data rooms then this allows the buy side to create a more automated due diligence process. Some examples here are the AI-assisted recognition of patterns and inconsistencies in annual financial statements, or the identification of contract durations and notice periods in rental and employment agreements.

Another field of application in the context of virtual data rooms for cross-border transactions is AI-assisted document translation. In this case, data room users are able to display document contents in their preferred language.

Please note: This has the added advantage that none of the contents are entered into separate translation tools outside of the data room and thus no sensitive information is uploaded to the internet.

Besides due diligence activities on the buy side, the application of AI in virtual data rooms on the sell side can moreover be used, among other things, to automatically categorise documents and allocate them to the corresponding index reference points. All parties could thus benefit from the application of AI in virtual data rooms and reduce their respective manual workloads (cf. summarised in Table 2).

3. Potential risks and limits

The use of AI will have particular benefits when large volumes of data are supposed to be processed. Risks could however arise for data protection reasons, for example, if AI models are trained using personal data. Here, care should always be taken to ensure that companies or the data room providers who offer AI systems comply with the data protection regulations and safeguard personal data.

A substantial limitation of AI is moreover its lack of ability to contextualize. While AI algorithms can identify patterns and relationships in the analysed data, yet they do not fully understand the context. This can lead to faulty results in the case of automatic evaluation. In this regard, human expertise and experience within the scope of due diligence are still vital for interpreting the results of the AI analysis and for drawing conclusions from it.

4. Conclusion: The combination of human and machine as the key to success

Decisions taken by humans are often prone to error and could be based on prejudice. This can notably be observed with regard to decisions that seem complex and are time critical and marked by uncertainty.

The use of AI in the context of the due diligence process can however help to minimise such sources of errors and thus also to provide for more neutrality and transparency. Furthermore, with AI the increasing complexity of dealing with large data sets and data structures can be reduced and time-critical processes can be accelerated.

Although, AI is currently still coming up against its limits, notably in the area of the contextualisation of patterns and relationships in analysed data.

Ultimately, the interplay between humans and machines in the due diligence process represents the crucial key to success.

IN BRIEF

Damage caused by pruning on a neighbouring property can lead to compensation

In disputes between neighbours illegal pruning of plants is punishable by heavy fines. The amount of compensation that can be claimed here will depend on the specific case. Recently, a case was put before the Frankfurt/Main court of appeals (Oberlandesgericht, OLG) where a 70-year-old stock of trees had been pruned.

The OLG Frankfurt, in its ruling of 6.2.2024 (case reference: 9 U 35/23), made a decision in the case of a woman's large property with a stock of trees that was around 70 years old. The trees had been regularly pruned by a specialist company. At the boundary of the property, although clearly on the woman's property, stood two trees. The woman agreed that her neighbour could prune back the overhanging branches. Subsequently, when she was absent, the man took this opportunity to enter her property and severely pruned both trees. Thereafter, not a single leaf was left on the birch tree and the cherry tree, which was almost ready for harvesting, had been cut right back. It was not certain if the trees could recover. Thereupon, the woman sued to obtain compensation of almost €35,000.

Manneken Pis - fountain sculpture in Brussels

However, she received only €4,000 and appealed to a higher court. The OLG referred the dispute back to the regional court. It has to reopen proceedings in order to adequately clear up the matter of how to calculate the amount of compensation.

According to settled case law, when a tree is destroyed, normally, full compensation does not have to be paid because providing a replacement in the form of a transplanted mature tree is usually associated with high costs and would thus be disproportionate. Therefore, the claim for damages is instead focused on a partial restoration by planting a new young tree and on the entitlement to compensation for the residual loss in the value of the property.

Outcome: Here, the loss in value has to be estimated. In exceptional cases, the full cost of replacement would only have to be paid if an economically rationally thinking person would at least suggest replacing the type, location and function of the tree with a tree of the same kind. For this reason, when assessing the compensation for damages it will be necessary to clarify the function of the trees for the specific property.

AND FINALLY...

"It's nice to be right sometimes."

Peter Ware Higgs (29.5.1929 – 8.4.2024) was a British physicist. Higgs predicted the so-called God particle in the 1960s. It was only in 2012 that the nuclear research centre CERN, in Switzerland, was able to prove the existence of such a particle (which by then was known as Higgs boson). In the following year, Higgs together with François Englert, a Belgian, was awarded the Nobel Prize in Physics.

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