PKF newsletter

PKF
Accountants & business advisers

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Editorial

Dear Readers,

No doubt you have heard about the demanding requirements of the tax authorities with respect to the accuracy of a driver's log book and about the types of difficulties that can arise in relation to gaining acceptance for it from the tax authorities. The requirements with respect to the accuracy of cash accounting records are similarly difficult to meet but much less well known. Therefore, particularly in business sectors in which payments are frequently made in cash (retail, handicrafts etc.) scrutinising cash accounting records has become a focus of tax audits. This topic is highly relevant because if accounting irregularities are detected then, if necessary, the authorities are entitled to make estimates that could entail considerable additional tax charges. In our Focus section, therefore, you can read about what you can do to minimise such risks.

Besides this main focus, in this issue, there are a number of articles on topics related to the overall theme of employment relationships. In the Corporate Taxes section, we point out the tax risks related to pension commitments and we have advice, accordingly, for corporations and their shareholding managing directors on the need for action in this respect. Furthermore, in the Personal Taxes section, we discuss a new Federal Fiscal Court (Bundesfinanzhof, BFH) ruling that is advantegeous with regard to payroll tax in cases where employees have been granted price advantages and discounts by third parties. Finally, in the Legal section, we discuss a ruling on the obligation to pay compensation for overtime.

Moreover, we hope that the other topics, too, will be stimulating reading for you and will serve as a basis for your own reflections.

Yours sincerely,

Your PKF Team

FOCUS

Accounting for cash transactions in the tax audit spotlight

If, during a tax audit, formal errors in a particular section of the accounting documentation are considered to be evidence of material errors, the tax auditor has the option to reject this section and to replace it with his/her own estimates. Companies that regularly generate cash proceeds can face considerable rishs as the local tax offices already have the backing of the fiscal courts for add-back estimates of up to 10% on top of booked turnover (and not just on profits). The resulting additional tax and interest payments can quickly become a threat to the survival of a company. Therefore, it is very important to ensure the accuracy of the accounting records for cash. Here, particular attention should be paid to the completeness of documentation.

I. Cash registers

Here a distinction should be made between the “traditional” non-PC based cash registers and PC-based cash registers. Irrespective of the system that is used, the completeness of the record of transactions has to be ascertained by means of sequential numbering of the end-of-day totals tickets (so-called Z-reports). Moreover, the data has to include all cash register transactions and not just the end-of-day totals. Cancellations should not result in a record being deleted.

In the case of **traditional cash registers**, the requirement to log all turnover details can exceed the memory capacity. Nevertheless, the tax authorities insist on a complete recording of all transactions. Therefore, if necessary, existing cash register systems have to be adapted to these requirements by means of software updates and additional memory.

If **PC-based cash register systems** are used, it should be noted that with the help of software plug-ins (so-called "zappers“) daily sales totals can be completely erased and/or records overwritten by new values. During tax audits, the tax authorities might focus on this particular issue, even if you only use a basic version and are not aware of zappers.

Caption: Accuracy of cash accounting records - it's better to make sure beforehand than to have to make additional payments subsequently.

II. Open tills

Open tills are ones that do not automatically record all transactions, e.g. a cash box on the sales counter and the "petty cash" in the administration office. For these tills, transactions have to be recorded manually in a **cash book.** For that purpose either the individual transaction are recorded or a cash report is drawn up.

In the case of individual transaction records, the required entries have to be made immediately after each deposit or withdrawal and the new cash balance has to be recorded each time. The entries have to be made in the order of the actual cash movements.

If a considerable numer of transations is performed each day it is too time consuming to record the individual transactions. In such cases, it is possible to draw up a **cash report**. The receipts are not recorded individually but calculated on a daily basis by deducting the opening balance and deposits from the closing cash balance that has been counted and adding back the business expenses and withdrawals.

Irrespective of the type of cash accounting the above-mentioned completeness requirement still applies. In particular, it should not be possible to make any retroactive amendments. Therefore, "self-developed" cash books in spreadsheet programmes do not usually stand up to the scrutiny of the local tax office.

Note: Incidentally, a business owner's private purse is not deemed to be a(n) (open) till - it is not any type of till at all. For sole traders, or shareholders in a partnership, business expenses paid out of this are private contributions and, conversely, business proceeds that flow into the "private wallet" are private withdrawals.

III. Recommendation - comply with the documentation requirements.

The risk of having to pay additional tax in the wake of a tax audit due to formal errors in cash accounting depends on the volume of cash transactions in a company. However, if you conduct a considerable number of such transactions, you should take the time to examine all your tills to determine whether or not the accounting for cash transactions and the documentation are accurate.

TAX

Corporate Taxes

Stricter guidelines, issued by the tax authorities, for pension commitments to shareholding managing directors

Who for: Corporations that have made, or would like to make, pension commitments to their shareholding managing directors as well as the respective shareholding managing directors.

Issue: The BMF, in its latest decrees, has made two significant amendments to its guidelines for pension commitments to shareholding managing directors:

- pension commitments to shareholding managing directors shall be acceptable for tax purposes only if there is a probationary period, as a rule two to three years after joining the company, in which no pension commitment are granted. Furthermore, a newly formed corporation may not make a pension commitment to its shareholding managing director until five years after its incorporation (waiting period). Up to now, an infringement of this provision meant that, until this waiting period was over, a so-called hidden profit distribution was deemed to have taken place. However, allocations to pension provisions made after the aforementioned period could be offset against profits. For pension commitments made after the 29.7.2010, if there has been an infringement of the probationary/waiting period, the authorities will no longer recognise any of the allocations to pension provisions as being tax deductible at any time.
- If shareholding managing directors are not being paid a regular salary but are being remunerated for their activities with pension commitments (pension commitments not based on salary conversion), the tax authorities have adopted the negative ruling. The formation of pension provisions in a tax efficient way is, thus, not permitted. This also applies to commitments that have already been made.

Recommendation: You should review all pension commitments made to shareholding managing directors after 29.7.2010 and check if the probationary/waiting period was observed. If there has been an infringement, a reversal and a new commitment after the end of the probationary/waiting period may be possible. With regard to pension commitments not based on salary conversion, it should be noted that despite the new, stricter guidelines issued by the authorities there is still scope for new commitments, based on salary conversion that can be offset against tax. However, the respective pension commitment need to be considered carefully and drafted accordingly. For more details please do not hesitate to contact your PKF consultant.

More Information: The BMF circular on pension commitments not based on salary conversion (of 13.12.2012) and on probationary/waiting periods (of 14.12.2012) can be found online at www.bundesfinanzministerium.de. (German version only)

No writedowns on non-interest bearing receivables

Who for: Companies that have granted interest-free loans.

Issue: A parent company had provided a loan to its subsidiary. As the loan was interest-free, the parent company discounted the loan receivable and, under expenses, recorded the difference between the nominal value and the present value as a writedown.

When dealing with this issue, the Federal Fiscal Court (Bundesfinanzhof, BFH), ruled that that the acquisition cost of the receivable was equivalent to the nominal amount. Furthermore, the interest-free receivable that has to be paid back in the long-term is, admittedly, worth less than a receivable of an equivalent amount that can be collected in the short term. However, this impairment in value should not be recognised as "presumed to be permanent" as, over the course of time, the value will increase and, at maturity, ultimately the nominal value will be achieved. Therefore, a writedown may not be reported.

More Information: The BFH ruling of 24.10.2012 (case reference: I R 43/11) is available online at www.bundesfinanzhof.de.(German version only).

Personal Taxes

Payroll tax - BFH has simplified the the rules regarding the treatment of benefits granted by third parties

Who for: Employees who obtain price advantages and discounts from an employer's suppliers.

Issue: Employees can often buy goods at a discount from the suppliers and customers of an employer. Recently, the Federal Fiscal Court (Bundesfinanzhof, BFH) had to rule on a case in which hospital employees were obtaining pharmacy products at a discount from a company which was also supplying the employer (the hospital provider) with pharmacy products. The supplier initiated this employee advantage programme and it was made known to the employees with the permission of the employer. The employees participated in the programme by ordering directly from the supplier.

The BFH did not view the provision of goods at a discount as wages paid by a third party which would be subject to payroll tax. In the opinion of the BFH, price advantages and discounts that employees obtain from a third party can only be deemed to be wages if they represent the fruits of the employees' labours for the employer and if they have a connection with the employment relationship. Just because an employer was involved in providing the discount does not mean that the discount should be automatically presumed to represent wages. This applies particularly in cases where the employer was only aware of, or should have been aware of the granting of discounts. Relevant is only whether or not the benefits granted by third parties are a bonus, or remuneration for a service rendered by the employees for the employer within the scope of their employment relationship.

Recommendation: The BFH ruled in favour of employers by increasing the requirements that determine active involvement in the granting of advantages by third parties and, thereby, reducing an employer's liability risk. Assessment notices in which the tax authorities have taken a stricter view should be held open.

More Information: The BFH ruling of 18.10.2012 (case reference: VI R 64/11) can be accessed at www.bundesfinanzhof.de (German version only).

Photovoltaic systems on private buildings - input tax deduction for general building costs virtually impossible?

Who for: Owners of private buildings with photovoltaic systems on the roof.

Issue: Operators of photovoltaic systems who supply energy utilities with the electricity that is generated in return for remuneration can, in principle, deduct the input VAT related to the costs of installation and operation of the system. This also applies to the costs of installation, or refurbishment of the roof of the building on to which the system is mounted. Insofar as these costs cannot be attributed directly to business use, the share of the building that is used for business purposes needs to be at least 10%. In 2011, the BFH decided, in this respect, that the calculation of this limit should be based on the relation between the (notional) charge for renting out the roof to the (estimated) rental charge for the entire building (cf. PKF News 12/2011).

The above-mentioned ruling, in the meanwhile, has been accepted by the tax authorities. However, the tax authorities have made reference to the low level of roof rental charges. Taking into consideration the usual annual rental charges of around € 2 – 4 /sqm, this would rule out the deduction of input VAT for general building costs in many cases.

Recommendation: It is likely that, in the future, the tax authorities will look more closely at input tax deduction from general building costs by operators of photovoltaic systems on private buildings. Therefore, you should check to what extent an input tax deduction is possible if a notional rental charge is taken into consideration. If your calculation is based on an annual rental charge of more than €3/sqm, the authorities might, potentially, expect you to produce evidence accordingly (such as actual rental offers).

More Information: The relevant decision of the Bavarian State Tax Office of 7.8.2012 can be found at www.finanzamt.bayern.de/lfst (German version only.

ACCOUNTING

Scope of accounting treatment of aggregation or apportionment accruals

Who for: Businesses which set up accruals for contingent liabilities whose economic causes have an impact on subsequent financial years (e.g. in the case of restoration obligations).

Issue: In the above-mentioned cases of so-called aggregation or apportionment accruals, the costs are usually broken down over time in accordance with the principles of economic causes. In this respect and based on the assumption of an advantegous development, there are in principle two recognised methods:

(1) In the present **value method**, first of all, the total nominal amount that has to be recognised in the accounts is evenly divided. The amount of the accruals on a respective appointed date is the result of discounting the cumulative proportional required settlement value. For example, at the end of a three-year lease term (starting 2.1.01) fixtures added by the lessee have to be removed and the cost of this is € 300 k. The interest rate is 4.5%. This results in the following values.

Date	31.12.01	31.12.02	31.12.03
Pro-rata Required Settlement Value	100.00 k €	100.00 k €	100.00 k €
Accrual Appropriation	91.57 k €	191.38 k €	300.00 k €
Operating Expense	91.57 k €	95.69 k €	100.00 k €
Interest Expense	0.00 k €	4.12 k €	8.62 k €

(2) In the **equal distribution method**, however, the operating expense is distributed on an annuity basis. Using the sample data this results in:

Date	31.12.01	31.12.02	31.12.03
Annuity	95.63 k €	95.63 k €	95.63 k €
Accrual Appropriation	95.63 k €	195.57 k €	300.00 k €
Operating Expense	95.63 k €	95.63 k €	95.63 k €
Interest Expense	0.00 k €	4.31 k €	8.80 k €

The calculations show that with the present value method, in contrast to the equal distribution method, the operating expense increases over time and, compared to the equal distribution method, the accumulation of the accruals is delayed. Furthermore, with the equal distribution method, a lower operating expense but a higher interest expense is reported over the entire period (in the above example: a difference of € 0.37 k).

Recommendation: The right to choose between the two methods opens up scope regarding the accounting strategies. It should be noted that exercising that choice is subject to the consistency rule and while the (initial) impact of the present value method results in lower operating expense this is reversed over time. With regard to accounting and tax strategies, it might be interesting to have a complete shift between operating expense and interest expense. Ultimately, it should be noted that in the tax accounts the valuation is in accordance with the present value method and is based on an interest rate of 5.5%. Therefore, if necessary, deferred tax assets and liabilities will have to be recognised in the amount of any differences between the methods used in the financial accounts and the tax accounts. For details please do not hesitate to contact your consultant.

More Information: Details of the accounting treatment of provisions in the financial accounts are discussed in an IDW (Institute of Public Auditors in Germany) opinion statement (IDW RS HFA 34), that you will find in the "IDW-Fachnachrichten 1/2013" (p. 53 ff.) (German version only). For information on the accounting treatment in the tax accounts, a BMF (Federal Ministry of Finance) circular of 26.5.2005 (German Federal Tax Gazette (Bundessteuerblatt, BStBl.) I 2005 p. 699 ff)) is of relevance.

LEGAL

Unternehmergesellschaft (German limited liability enterprise company) – personal liability if under the guise of a "GmbH"

Who for: Managing directors of a GmbH (German limited liability company) and a haftungsbeschränkte Unternehmergesellschaft (German limited liability enterprise company - less complicated to set up than a GmbH with a share capital requirement of € 1).

Issue: Giving false, or incomplete statements about the (limited liability) legal form in business transactions

can lead to personal liability for the individual (managing director), who conducts the transaction, towards the contracting party. This does not only apply to the GmbH but also to the variation on the GmbH, introduced in 2008, the haftungsbeschränkte Unternehmergesellschaft (German limited liability enterprise company). The relevant statute stipulates that it is mandatory to state the legal form of the company in German either as "Unternehmergesellschaft (haftungsbeschränkt)", or "UG (haftungsbeschränkt)" instead of the usual "GmbH" suffix. In legal relations, it should be possible to identify that the share capital of this company is less than € 25 k.

Personal liability for assuming a false legal appearance (Rechtsscheinhaftung) also applies to an Unternehmergesellschaft (haftungsbeschränkt) if there have been transactions on behalf of a German enterprise company while making illegal use of the suffix "GmbH". This was recently clarified by the Federal Court of Justice (Bundesgerichtshof, BGH). It ruled on a case where a German enterprise company with share capital of just € 100 presented itself as "...GmbH u.g.". Even if the suffix "GmbH" indicates limited liability, it gives nevertheless rise to the false impression that the company, at least at one time, had a liability fund of € 25 k. This deception in legal relations leads to personal liability of an individual who conducts a transaction. Apart from that the the company is jointly and severally liable. However, the BGH did not clarify whether the managing director's liability is limited to a sum which is the equivalent of the difference to the minimum share capital of € 25 k, or if it is deemed to be unlimited.

Recommendation: German limited liability enterprise companies, or their managing directors are strongly advised to adopt the (admittedly cumbersome) legal form of the company precisely. Otherwise, the main advantage of this legal form, namely full limited liability with a low initial investment, will be lost.

More Information: The BGH ruling of 12.6.2012 (case reference: II ZR 256/11) was published online at www.bundesfinanzhof.de. (German version only).

Obligation to pay compensation for overtime?

Who for: Employers and employees who work overtime.

Issue: There is no rule of law that says that all overtime, or being officially in attendance beyond the agreed working hours, has to be remunerated. Nevertheless, in principle, in the absence of (effective) rules governing remuneration, the employer is obliged to pay for overtime work if, according to the circumstances, it can only be expected if it is remunerated. Over and over again, the courts have had to consider this issue.

The Federal Labour Court (Bundesarbeitsgericht, BAG), on 22.2.2012, ruled in favour of a warehouse employee, with a monthly gross salary of € 1,800.00, whose employment contract included an agreement that, besides the 42 hour working week, the claimant was obliged to work overtime without extra payment whenever there was an operational requirement. It was the view of the court that, given the level of the gross salary, overtime could only be expected if it was paid for. Moreover, the contractual exclusion of any additional payments for overtime was invalid as an employee who is deemed to be reasonably well informed would not have been able to identify what work the claimant was supposed to do in return for the regular gross salary.

Then again, in a ruling on 27.6.2012, the same court clarified that an employer can refuse to pay overtime if:

- highly specialised services have to be provided, or
- if the employee receives a considerable amount of other remuneration components apart from the fixed salary, or
- if the remuneration paid is, overall, clearly very considerable and exceeds the income threshold ("Beitragsbemessungsgrenze") for contributions to statutory pension insurance.

In a case comparable to the one of 22.2.2012, the contractual gross salary of a sales representative was low, however, he also received in addition significant commission payments for business transactions arranged by him. Once again, according to the contract, remuneration for any overtime was deemed to be included in these payments. In this case, the court presumed that an overtime payment could not be expected and justified unless there were special circumstances, or appropriate customary practice. However, this was not the case, as the employee was receiving work-related remuneration and additionally, for some of his tasks, a not insignificant amount of commissions. Therefore, the employee came away empty handed.

Recommendation: A clause that regulates flat-rate overtime payment is only deemed to be clear and understandable if, in the employment contract itself, it is possible to identify the work that should be performed and the timeframe. At the time the contract is concluded, the employee should be able to discern what, potentially, s/he can expect and what s/he will have to perform, at most, in return for the agreed remuneration. We recommend a review of the contents of employment contracts.

More Information: The BAG rulings of 22.2.2012 (case reference: 5 AZR 765/10) and of 27.6.2012 (case reference: 5 AZR 30/11) can be viewed online at www.bundesarbeitsgericht.de (German version only).

CORPORATE FINANCE

Bridging divergent price expectations in a corporate acquisition

Who for: Buyers and sellers of businesses.

Issue: In the course of a corporate acquisition, a vendor does not want to sell at less than fair market value. By contrast, if the purchase price is too high, buyers might have to justify themselves to their financial backers. In practice, while taking into consideration this clash of interests, but in order to reach an agreement, use is made of various strategies. Frequently, agreements are made, in particular, on earn-outs, reinvestments or vendor loans. Specifically:

(1) with an **earn-out agreement**, the vendor of a business may receive additional payments in future in addition to the current purchase price if certain condition are fulfilled. For that purpose performance metrics that are commonly used, e.g. exceeding a particular annual operating result. From the vendor's point of view, it is important that the measureable achievement objective is clearly defined in an earn-out clause in a company acquisition contract in order to minimise the risk of a buyer influencing the indicator after the acquisition. This helps to avoid disputes in the future. Furthermore, experience has shown that it is generally advisable to restrict the validity of earn-out clauses to a maximum of two years.

(2) In the **case of a reinvestment**, the vendor either sells only a part of his/her interest, or, as a first step, the entire holding is sold and, in the second step, the vendor receives shares in the acquiring company. At the same time, e.g. a put option on the shares owned by the vendor can be agreed upon. By exercising his/her option, the vendor then has the possibility of participating in the successful development of the company. Thus the buyer does not acquire an unencumberd shareholding but is faced with rights remaining with the vendor. Therefore, clear rules should be laid down, e.g. by means of a shareholders' agreement, as to what extent the vendor can be compelled (or "dragged along") to sell his/her minority share if the buyer wants to sell on the company.

(3) In the case of **a vendor loan,** the vendor sells the entire shareholding in his/her company and, subsequently, grants it, or the acquiring company, a loan. From the point of view of the vendor, granting the loan represents an investment with a potentially attractive return. The buyer may quote a higher purchase price for the company without an increase in his/her investment. The main aspects that have to be settled in connection with a vendor loan include: the term, the interest rate, repayment modalities as well as the provision of guarantees. Insofar as there are also banks participating in the company acquisition financing, experience has shown that it is very difficult to negotiate the provision of guarantees, or repayment before maturity. Indeed, vendors frequently even have to provide a letter of subordination with respect to their loan.

Recommendation: Insofar as, at the time of a transaction, a clearly determined purchase price cannot be negotiated, in view of the natural conflict of interest between the vendor and the buyer, this does not necessarily mean that the purchase negotiations have failed completely. In such a case, the strategies described above, or a combination of them, can make it possible to bridge the divergent negotiating positions. Nevertheless, the impact of the chosen strategy from an economic, tax or legal point of view should be assessed carefully in advance. With respect to tax aspects, this applies in particular to reinvestments and vendor loans, as the granting of a vendor loan as well as the acquisition of a reinvestment shareholding in an acquiring company always have to be funded by sales proceeds that have already been taxed.

IN BRIEF

A new approach to restructuring

In an environment that, for a number of years now, has been characterised by the continuing economic and financial crisis, many companies are no longer in a position to master of crisis on their own. Against this background, on the 1.3.2012, the German Law to Facilitate the Restructuring of Companies (Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen, ESUG) came into force with the aim of changing insolvency proceedings with a view to raising the success rate of rescuing businesses that can be restructured. It has now been about one year since the opportunity to apply the new ESUG instruments became available and various PKF restructuring teams have taken stock of the situation. In a recently published edition in the PKF Themenwissen (PKF Specialist Knowledge) series (please refer to www.pkf.de, under 'Publikationen' (German version only)) you will find information about the experiences to-date as well as advice on how to deal with the new legal provisions.

Annual Tax Act 2013 - it's not over yet

In the February issue of PKF News, we reported that, in January 2013, the Annual Tax Act 2013 had failed to gain parliamentary approval for the time being. However, virtually at the same time as this newsletter went to press, the Finance Committee of the Bundestag (lower house of German parliament) passed a version of this law that did not include the disputed points.

However, at the same time, the Bundesrat (upper house of German parliament) also presented its own draft for an Annual Tax Act. It remains to be seen, whether one of the two drafts is approved by both chambers, or a compromise is reached. In any case, we hope to be able to give you a more detailed report in the next newsletter.

AND FINALLY...

"Formerly we suffered from crimes; now we suffer from laws."

Tacitus, Roman historian, 55 AD

Impressum

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