PKF newsletter

PKF
Accountants & business advisers

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Editorial

Dear Readers,

In the last few months, in the press, radio and television as well as other media, more and more frequently, there have been discussions of the various aspects of the topic of "tax evasion". However, these reports seek mass audience appeal and, thus, often focus on prominent cases as well as on declarations of political intent such as, for example, the one to abolish banking secrecy in the EU. By contrast, the presentation of the current legal regulations and further framework conditions is disregarded. Therefore, in our Focus section, we have filled in the gaps with regard to this controversial area.

At the same time as this newsletter went to press, after seemingly endless toing and froing, some important parts of the original Annual Tax Act 2013 did indeed finally come into force. Therefore, in this issue, we have provided a, virtually up-to-the minute, short overview of selected measures included in this act. You will find detailed analyses in the next issue.

By contrast, our reports, above and beyond tax law topics, on other legal aspects and on accounting issues are hardly subject to political constraints – such as, for example, the new rules on the accounting treatment of pension commitments, or the employer-friendly aspects of a recent Federal Labour Court (*Bundesarbeitsgericht*, BAG) ruling. From a business point of view legal uncertainties can be avoided by agreeing on purchase price clauses. When used within the scope of a corporate acquisition contract, the purchase price clause offers the parties risk protection. Read more about this on p. 7.

Yours sincerely,
Your PKF Team

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FOCUS

Tax evasion and voluntary self-disclosure – how much room for manoeuvre is there still left?

Since the introduction of withholding tax, most domestic German private capital gains no longer have to be declared in a tax return. Yet, this does not usually apply to foreign income. However, if the necessary information is omitted this could easily lead to a case of potential tax evasion. When the taxpayer realises he has omitted necessary information he is faced with highly complex issues and needs to decide if and how a voluntary self-disclosure to avoid penalty is advisable. Current developments, such as extended information exchange and the clear tendency towards greater surveillance pressure are exacerbating the necessity for the taxpayers concerned in this respect to think about ways of getting around this problem promptly and making use of the room for manoeuvre that is still left.

I. Preconditions for effective voluntary self-disclosure to avoid penalty

An effective voluntary self-disclosure will result in no criminal sanctions being imposed for tax evasion irrespective of the period of time or the amount involved. For an effective voluntary self-disclosure, all of the following preconditions have to be met:

(1) The taxable events that have not been declared to-date (thus, in the case outlined above, the income) have to be fully disclosed in a verifiable way.

(2) The ommission may not have already been detected by the authorities.

(3) The tax plus interest (6 % p. a.) and, potentially, a penalty charge have to be paid quickly and in full.

Not a paper tiger – the tax authorities are grasping with their sharp claws

II. Current developments that are exacerbating the problem

Whether, or not tax evasion has already been detected by the authorities (precondition 2) is difficult to ascertain from the outside and likewise from a legal point of view. Thus, it has not yet been finally clarified whether tax evasion is deemed to have been detected at the point in time when the tax authorities purchase **data CDs**, or rather, only when the authorities start to evaluate these CDs and obtain specific information about the actual tax evasion.

Moreover, as international information exchange has increased in recent years, this could lead to additional problems. This can be seen in, among other things, numerous new German tax information exchange agreements with countries designated as "tax havens" such as, for example, Liechtenstein, the Bahamas and the British Virgin Islands.

Note: Furthermore, while the stalled *German-Swiss tax treaty* attracted media coverage, it has however, gone almost unnoticed that, since 1.2.2013, the German tax authorities have, nevertheless, been able to obtain considerably more tax information about the investments of German investors in Switzerland. From now on, by means of so-called "group requests" the German tax authorities may submit administrative assistance requests for information on investors with group-related behavioural patterns, such as, for example, the setting up of foundations, trusts, etc. In the light of the new Swiss Tax Administrative Assistance Act, it has to be assumed that this will not remain a paper tiger and that Switzerland will respond to these requests.

III. A tendency towards greater surveillance pressure

It is to be expected that surveillance pressure on taxpayers will increase. In recent years, for example, the OECD, in its model agreement, has extended the possibilities that exist for the exchange of information by adding regulations on the above-mentioned group requests.

Note: As this model forms the basis of many German treaties, in the future, you should expect an increase in the number of actual agreements with such possibilities. In addition, the "pressure for tax honesty" in Germany will increase further. This is reflected in the current debates

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about a change to, or even the abolition of voluntary self-disclosure to avoid penalty. Moreover, just recently, the *Bundesrat* (upper house of German parliament) passed a draft law on combating tax evasion effectively and, in addition, is calling for a new so-called "blacklist" of tax havens which are subject to a considerable burden of proof in order to have economic links recognised for tax purposes.

IV. Conclusion – voluntary self-disclosure only with expert advice

The current situation as well as the expected trends suggest that remaining gaps with regard to taxable events will have to be filled in with increased urgency by the taxpayer. However, before making a voluntary self-disclosure, those potentially concerned should seek advice from experienced specialists on account of the, usually, significant tax risks as well as prosecution risks.

TAX

Corporate Taxes

"Annual Tax Act 2013" reloaded – Administrative Assistance Directive Implementation Act has been passed

Who for: Companies and business owners.

Issue: At the beginning of June, the above-mentioned law, the replacement of the stalled Annual Tax Act 2013, was successfully passed. It includes a number of separate amendments, a selection of which we have outlined for you below:

- The Act includes a defensive regulation against the so-called "Goldfinger Model", a tax shelter which, up to now, made it possible to integrate foreign business in order to generate tax advantages from, for example, the purchase and sale of gold.
- The concept of attribution of profits at foreign permanent establishments has been aligned with the considerations of the OECD (cf. issue 11/2012).
- Structuring possibilities, previously within the scope of gift/inheritance tax that allowed for the tax privileged transfer of assets by means of so-called cash companies will be combated through defensive regulations (cf. issue 09/2012).
- The implementation of EU regulations has given rise to various changes in VAT law and thus, in particular, the issuing of invoices (cf. issue 11/2012).
- The German Real Estate Transfer Tax Act lays down that legal transactions that confer a direct and/or indirect economic interest of at least 95 % in a company that holds German real estate will also trigger tax.
- The international exchange of information on tax matters has been extended (cf. issue 11/2012).

Recommendation: The various individual measures that have been laid down in the above-mentioned law require a detailed examination of the respective topics. Certainly, in most cases, the abolition of the "Goldfinger Model" will probably be of little interest, while, for example, the modifications to VAT should generally have greater practical implications. The actual consequences for you and your company can only be clarified individually. Please do not hesitate to contact a consultant at your local PKF office.

Payments by employees for company cars – preconditions for a reduction in payroll tax

Who for: Employers whose employees bear the costs of the private use of their company cars.

Issue: If a company car is also provided for the private journeys of an employee, then this constitutes a non-cash benefit that is subject to payroll tax. In a new circular, the Federal Ministry of Finance (*Bundesministerium der Finanzen*, BMF) has now provided a detailed explanation of the extent to which payments by an employee can reduce the amount of tax. According to the circular, with effect from 1.7.2013, if an employee pays for the private use

- a lump-sum amount that is not linked to use (e. g. a fixed monthly lump-sum),
- an amount based on the distance travelled (e. g. € 0.20 per private kilometre), or
- the lease rates,

then this reduces the assessment base for payroll tax, insofar as the payment by the employee has been agreed in the employment contract, or in some other manner in accordance with public service law or labour law. By contrast, if the employee assumes, fully or partially, particular vehicle costs (e. g. fuel costs, insurance, etc.) this has no impact on the assessment base for payroll tax.

Recommendation: In future, in order to be able to take payments by an employee into consideration and, thus, reduce the payroll tax, you should review the existing rules of your company and, if necessary, adapt them as outlined.

More Information: The above-mentioned BMF circular is from 19.4.2013, besides the contents that have been mentioned, it gives a general overview of the impact on payroll tax if an employee shares the costs of a company car and includes several sample calculations.

Personal Taxes

Deduction of debt interest even after a debt-financed rental property has been sold?

Who for: Taxpayers who sell their debt-financed properties that have been let and are not able to pay off the (remaining portion of the) loan with the proceeds from the sale.

Issue: According to a new ruling from the Federal Fiscal Court (*Bundesfinanzhof*, BFH), debt interest can also be deducted retroactively as cost related to income from letting and leasing when a property is sold and insofar as the proceeds from the sale are not sufficient to repay the loan that was used to finance the property (cf. previous report on this in issue 10/2012). In a Federal Ministry of Finance (*Bundesministerium der Finanzen*, BMF) circular, from 28.3.2013, the tax authorities have now clarified the preconditions under which this cost deduction will be allowed. According to this, sales based on a contract concluded from 1.1.1999 onwards have to fulfil the following conditions.

- The purchase and the sale of the property took place within a period of ten years.
- The funds realised from the sale will be used primarily for the repayment of the loan.
- The intention to generate income from letting and leasing existed right up to the sale of the property.

Generally, in the case of a non-taxable property disposal after the ten-year divestment period, the retroactive deduction of debt interest as costs related to income shall be disallowed. Insofar as the taxpayer has used the funds realised from the sale for another purpose, in contravention of the second precondition, a deduction of costs related to income would be out of the question. The third precondition would not be fulfilled if, for example, the property was being used as the taxpayer's own permanent residence, or if the property had been continuously vacant and there had been no attempt to let it out. In such cases, the tax authorities would assume that the intention to generate income was abandoned and, consequently, would disallow the deduction of debt interest.

Recommendation: In order to avoid a dispute with the tax authorities, it is recommended to take these conditions into consideration when conducting a property sale. Should structures deviate, you should contact us in good time in order to clarify the extent to which, nevertheless, the expenses could still be taken into consideration as costs related to income.

Cross-border taxation of employees – particularities for managing directors

Who for: Managing directors and their employers.

Issue: Like other employees, managing directions are in principle also taxed in the country in which they work. Most German double taxation treaties (DTTs) follow this rule (please see the relevant previous report in PKF Newsletter 04/2013). This rule which, initially, appears to be simple to apply, can, however, result in considerable difficulties especially with regard to managing directors whose place of work is subject to change. For example, if a managing director, who is domiciled in Germany, manages a company which is headquartered in another foreign country both from Germany as well as from the foreign company headquarters then s/he is carrying out his/her work in both states. Thus he is potentially, taxed in both states on the relevant portion of his/her remuneration. The apportionment of the remuneration can then be made e. g. on a pro rata temporis basis.

By way of derogation from this principle, some DTTs concluded by Germany include special rules for the taxation of managing directors. Thus, for example, the Austrian

DTT confers the right to tax solely on a corporation's state of domicile.

Recommendation: Insofar as an apportionment has to be made for tax purposes, you should obtain the relevant documentation for the apportionment key in good time. For an apportionment on a pro rata temporis basis you can also use, for example, travel expense reports or timesheets.

More Information: In the next issue of the PKF Newsletter we will continue our series of articles on cross-border taxation of employees with an article about the particularities relating to the transfer of employees within a group.

ACCOUNTING

Previous year figures in the annual commercial financial statement – material changes require explanations

Who for: Corporations and limited liability commercial partnerships (e. g. a GmbH & Co. KG).

Issue: Companies with the above-mentioned legal forms have to specify the corresponding previous year amount for each item in their balance sheets as well as in their P&Ls. If, compared with the previous year, there has been a material change in the constituents of an item, on account of exceptional measures, two alternatives are provided in the German Commercial Code for achieving comparability.

- In principle, an explanation in the notes to the accounts is required. The Institute of Public Auditors in Germany (*Institut der Wirtschaftsprüfer*, IDW) is of the opinion that this explanation has to include the main numerical differences.
- Alternatively, the previous year's figures could be adjusted in the balance sheet and in the P&L. However, these measures may not impinge on data booked in the previous year and may not result in changes to equity or to the results of the previous year. By contrast, formal adjustments, such as reclassification or standardisation of disclosure, are permitted.

Over and above these rules, the German Commercial Code has other special provisions. Thus, for example, changes to accounting and valuation methods have to be specified and justified while showing their impact on the financial position, cash flows and the results of operations.

Recommendation: If the previous year's figures are not comparable then, in practice, providing an explanation of the amendments is how the rules are commonly applied. By contrast, adjustments to the previous year's figures should be an exception, because, among other things, the use of notional figures as values for the previous year is not permitted. However, such "pro forma values", provided as voluntary additional data, can increase the informational value of an annual financial statement.

More Information: Further details about stating previous year's figures can be found in the accounting standard "IDW RS HFA 39". In the accounting standard "IDW RS HFA 44", the IDW presents opinions on the relevant issues with respect to consolidated accounts.

New rules for the accounting treatment of pension commitments in accordance with IFRS

Who for: Companies that prepare a/an (annual and/or consolidated) financial statement in accordance with International Financial Reporting Standards (IFRS).

Issue: As from financial years beginning 1.1.2013, IFRS financial statements will have to comply with new mandatory rules with respect to the accounting treatment of (so-called "performance-oriented") pension commitments. It is expected that the changes will have a significant impact on the economic situation. The new rules deal with various issues:

(1) Whereas, previously, in accordance with the so-called "corridor method", actuarial gains or losses did not have to be taken into account, from now on, it will be mandatory for them to be presented in their entirety and, concurrently, recognised in so-called "other comprehensive income" (OCI) directly in equity. At the same time, there is now a ban on reclassifying into profit and loss certain changes that were recognised directly in equity (so-called "recycling"). Previously, this was possible in particular circumstances. Ultimately, on the balance sheet, there should be a record of the amount of the difference between the pension liability and the plan assets guaranteed in the event of insolvency, thus, net liabilities or net assets.

(2) Insofar as, previously, an expected yield on plan assets was used, now, irrespective of the investment structure, the same interest rate shall be used for the valuation of the plan assets as the one used to discount the pension liabilities. Furthermore, the net interest charge, or net interest income, in the amount of the product of the discount rate as well as net liabilities or net assets according to the balance sheet have to be disclosed under either the operating result or net financial income/expense. In this way, the discretionary leeway that existed previously has been restricted.

Recommendation: For companies that previously used the corridor method, the changes are likely to result in, among other things, significantly higher equity volatility in the future. Mandatory use of a uniform discount rate for plan assets as well as for commitments will also have the effect that, at companies where the return on plan assets is actually higher, the interest income recorded in the P&L will be lower, while the "excess return" on the plan assets will only be reflected in other income (OCI) directly in equity. Therefore, we would encourage thinking about the extent to which you should draw the attention of users of financial statements (for example, banks or investors) to these effects, now already, within the scope of proactive financial communication. Please do not hesitate to contact your PKF consultant if you need any support in this area.

LEGAL

Children are held responsible for their parents' actions – news about bearing the costs of residential care

Who for: Individuals whose parents already are in residential care, or likely to be in the near future.

Issue: Frequently, a care home resident's own funds and the benefits paid out by the long-term care insurance system do not cover the costs for residential care. The welfare authority, that steps in then, usually checks to see if there is any recourse to the income of the (adult) children. In this respect, the Federal Court of Justice (*Bundesgerichtshof*, BGH) recently had the opportunity to clarify the following principles:

- The necessities of life, deemed to be adequate, of a parent who has social welfare needs are restricted to the subsistence level and, thus, to simple and cost effective accommodation.
- The current life situation is relevant, not the previous, possibly higher, standard of living. This applies even if the (adult) child who is obliged to provide financial support him/herself lives has a higher standard of living.
- Reference to cost effective accommodation may be unreasonable if, initially, the resident was still able to finance his/her care him/herself and the indigence claim arose later (e.g. as a result of a higher care level). The same applies if the (adult) child influenced the choice of residential care home.

Recommendation: Insofar as you are required by a welfare authority to contribute to the cost of the residential care of a parent, in individual cases it could make sense to question the appropriateness of the costs.

More Information: The BGH ruling of 21.11.2012 (case reference: XII ZR 150/10, please see www.bundesgerichtshof.de) includes further advice on the extent to which the welfare authority has recourse to an (adult) child's disposable assets that constitute his/her own retirement provisions.

Job applicant rejections – BAG has curbed rights to demand information

Who for: Employers and potential employees.

Issue: A software developer, born in Russia, was unsuccessful in her application for an advertised position. She subsequently maintained that she had not been invited to an interview solely on the grounds of her gender, her age (45) and her origin and made a claim for adequate compensation in accordance with the German General Equal Treatment Act.

However, the applicant was not able to provide any circumstantial evidence from which it could be presumed that there had been any discrimination. The case, which had reached the BAG, was unsuccessful. The mere fact that a decision could have been based on the aforementioned characteristics – which would be in breach of the German General Equal Treatment Act – is not sufficient in this respect. Nor is the employer even obliged to provide the missing information. The BAG, in its recent ruling, clearly rejected the notion that a job applicant has the right to demand information about if and potentially why another job applicant was hired. As the BAG had previously obtained the backing of the ECJ, such a right to demand information will not have any basis in Community law either.

Recommendation: Generally, in job applicant rejection letters, employers would be advised not to give any detailed reasons for their decision in order not to provide, unintentionally, circumstantial evidence of discrimination.

More Information: A press release on the BAG ruling of 25.4.2013 (case reference: 8 AZR 287/08) was published on www.bundesarbeitsgericht.de (No. 28/13, German version only).

CORPORATE FINANCE

Corporate acquisition contracts – purchase price clauses reduce uncertainty

Who for: Buyers and sellers of businesses.

Issue: In corporate transactions, the determination of specifying provisions that modify the purchase price, or the payment agreement terms is frequently considered vital. The reason for this lies in the respective interests of the buyer and the vendor. In the time between the signing of a contract and its closing, a buyer is exposed to the risk of the vendor withdrawing liquidity from the company and, thus, assets, e.g. through dividend or bonus payments. Then again, once the contract has been signed, the vendor would like to avoid disputes so that the purchase price can be paid promptly. In order to resolve this conflict of interest various mechanisms have become established and each has specific advantages and disadvantages. These mechanisms are:

- purchase price adjustment clauses,
- earn-out clauses,
- locked box mechanisms.

In **purchase price adjustment clauses**, it is agreed that the purchase price will be modified in a pre-defined way if, at closing, certain reference values derived from the financial accounts have changed compared to the starting situation (for example the last reporting date). Current purchase price adjustment clauses include rules that take into consideration net financial liabilities (net debt clause), net current assets (net working capital clause) and investments (capex clause). The advantage of this method, from the point of view of the purchaser, is that the risk of a possible reduction of value can be minimised right up to the closing. However, such types of clauses are complex and often lead to long negotiations and disputes.

In the case of **earn-out clauses**, besides the (immediate) payment of a basic purchase price, the parties also agree an additional, performance-related purchase price component. The amount of this additional purchase price thereby can be dependent on financial indicators (e.g. sales or EBIT), or other parameters (for example, product approvals). Earn-out clauses are frequently used in corporate acquisitions where the purchaser and the vendor have different price expectations on account of different assessments of the economic development of the company (cf. already discussed in issue 03/2013). The advantage of this method is that e.g. it makes it possible to execute transactions that are difficult to effect during economic crises and on account of restrictive lending. The disadvantage for the vendor is the delayed payment of the full purchase price as well as, potentially, the possibility for the purchaser to influence the indicators.

When concluding a contract that uses the so-called **locked box mechanism**, the parties to the contract agree on a purchase price that is based on a reference date that is already known before the contract is concluded (locked box date, as a rule, the last annual reporting date). Then, in the purchase contract, only so-called “anti-leakage covenants” are agreed. These should prevent value losses and the reduction of assets from the target business. From the locked box date onwards, the vendor receives interest on the purchase price. One advantage that can be seen in this method is that it avoids disputes about the valuations in the balance sheet on the closing date and their impact on the calculation of the purchase price. However, the determination of asset values and debts prior to the transfer date is fraught with problems. Furthermore, neither positive nor negative company developments can have any further impact on the purchase price. Thus, the locked box mechanism is a vendor-friendly mechanism. However, the longer it takes to go from signing to closing the more likely it is that, in particular, the purchaser will push for a mechanism with price adjustment clauses.

Recommendation: By agreeing on suitable mechanisms for determining the calculation, or the payment, of the purchase price, vendors and purchasers can hedge against the risks referred to above. When selecting and actually structuring these clauses, the parties should seek advice from experienced experts, possibly on the basis of the outcome of so-called due diligence.

IN BRIEF

PKF Issues Family Businesses series – *Mittelstand* (SME) financing

New rules, particularly at the European level, mean that the demands placed on *Mittelstand* parties seeking capital have increased greatly. The companies have to consider new and alternative ways of raising capital. You can read about the especially important developments in this area in the PKF Issues publication that is available at www.pkf.de (German version only). There are articles about, among other things, corporate bonds and new payment transactions under SEPA. Furthermore, there is a discussion of the basic rules for successful *Mittelstand* (SME) financing.

PKF Special – International transfer prices

More and more frequently, in international cases, tax auditors are focusing on the topic of the appropriateness of transfer prices as well as their documentation. A PKF Special on the experiences of PKF consultants in this area was published recently and you can download this at www.pkf.de (German version only).

AND FINALLY...

„Taxes only steer us to the edge of the abyss. Fees then do the rest.“

(Erhard Blanck (*1942), German non-medical practitioner, author and painter)

Impressum

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