PKF

Accountants &
business advisers

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Editorial

Dear Readers,

At the end of the year, some positive developments from a tax point of view can be reported. Firstly, we would like to draw your attention to the fact that the tax authorities have reduced restrictions on the deductibility of expenses related to tax-exempt income (partial income rule) and have adopted the more favourable ruling of the Federal Fiscal Court (*Bundesfinanzhof*, BFH). Furthermore, a positive development in the area of VAT is the easing of new legal provisions, in a new Federal Ministry of Finance (*Bundesministerium der Finanzen*, BMF) circular, with respect to the use of the German term "*Gutschrift*" (which can mean self-billed invoice but also credit note). However, the impact of the recent draft of a BMF circular about the taxation of international commercial partnerships is not clear, as the harmonisation with the Double Taxation Treaty (DTT) regulations could have both positive and also negative effects for those concerned.

By contrast, the fact that the BFH has broadened the scope for the recognition of employment contracts with relatives, from the point of view of the taxpayer, should be solely advantageous. We report on this on p. 4.

Unfortunately, however, there are restrictions with regard to inheritance and gift tax. In this respect, the BFH ruled that second homes and holiday homes are not considered to be family residences and, thus, cannot benefit from tax breaks. Moreover, particular attention should be paid to managing shareholder settlement accounts, if applicable, at commercial partnerships. According to a Federal Court of Justice (*Bundesgerichtshof*, BGH) ruling, under certain circumstances, an authorisation by the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, BaFin) may be required for this – more on this on p. 5.

We wish you a Merry Christmas and a successful start to the New Year.

Yours sincerely,
Your PKF Team

Contents

FOCUS

Easing of restrictions on the deductibility of expenses related to tax-exempt income – The application of the partial-income rule in the calculation of taxable profits

Recently, the Federal Fiscal Court (*Bundesfinanzhof*, BFH) has caught people's attention with several welcome rulings on the application of the partial-income regime in the calculation of taxable profits. Following on from this, in a Federal Ministry of Finance (*Bundesministerium der Finanzen*, BMF) circular, of 23.10.2013, the tax authorities have now stated their position and have endorsed the limits of deductibility of expenses related to tax-exempt income (partial-income rule) as argued by the BFH.

I. Easing of restrictions on the deductibility of expenses related to tax-exempt income via a BFH ruling...

In two rulings, from 18.4.2012, the BFH concluded that in cases of losses in substance of shareholder loans, held as business assets, e.g. due to write-downs to fair value or debt waivers, the restriction on the deductibility of expenses related to tax-exempt income (partial-income rule) is not applicable, irrespective of any reasons under company law (case reference: X R 5/10 and 7/10; cf. issue 7–8 /2012).

Furthermore, the BFH ruled that, in the case of "Betriebsaufspaltung" (company split into an owning and operating company), in principle, the restriction on the deductibility of expenses related to tax-exempt income (partial-income rule) applies to on-going expenses for business assets (e.g. machines, buildings, fixtures and fittings), insofar as the asset concerned has been provided at a discount to the operating corporation. However, it does not apply to such on-going expenses that relate to the substance of assets held as business assets and provided for the use of the operating corporation; in particular, the restriction on the deductibility of expenses related to tax-exempt income (partial-income rule) does not apply to depreciation and maintenance costs in relation to the assets provided (ruling from 28.2.2013, case reference: IV R 49/11).

II. ...has been adopted by the tax authorities

The tax authorities have declared the BFH rulings to be applied in all cases that are still open. Furthermore, the BMF clarified its views on three issues:

(1) Expenses for the provision of assets – In order to determine whether a shareholder's on-going expenses that are incurred in connection with the provision of assets to a corporation are fully deductible, or are subject to the restriction on deductibility of expenses related to tax-exempt income (partial-income rule), depends on the context in which they were incurred. In the event of an asset being provided at non-arm's length terms, or of a change determined by company law resulting in this, the tax authorities will (continue to) assume the existence of circumstances which involve the generation of future – partially tax-exempt – investment income. As a consequence, these expenses will only be partially deductible. However, – in accordance with the above-mentioned BFH ruling from 28.2.2013 – the restriction on the deductibility of expenses related to tax-exempt income (partial-income rule) will not apply to those expenses related to the substance of the assets that have been provided.

(2) Expenses for substance related to loans receivable held as business assets – Full tax deductibility is possible. In this case, the BMF has adopted the principles of the rulings from 18.4.2012 and has acknowledged that loans receivable are standalone assets and, as such, it is necessary to differentiate them from an equity stake. Losses that may arise have to be assessed separately on the basis of the provisions applicable to the respective asset. Writedowns or debt waivers on loans receivable, held as business assets, may be accordingly fully taken into consideration for tax purposes. Correspondingly, any reversal of a previous writedown that had been fully offset against income will be fully taxable.

(3) Financing costs – By contrast, the BMF holds the view, that in the case of financing costs connected with assets provided in return for a partial consideration or free of charge, the restriction on the deductibility of expenses related to tax-exempt income (partial-income rule) shall apply in all cases.

More Information: The administrative guidance from 23.10.2013 is available online on the BMF website (www.bundesfinanzministerium.de – German version only). The previous different opinion, as stated in the circular of 8.11.2010 (cf. issue 12/2010), has been expressly rescinded by the BMF. All the above-mentioned BFH rulings are available at www.bundesfinanzhof.de (German version only).

TAX

Corporate Taxes

Credit notes get the all clear – The BMF has relented!

Who for: Companies.

Issue: Last summer, we already reported on the new legal provisions for VAT invoicing of sales that were, or would be, realised after 29.6.2013. After a few months delay, the Federal Ministry of Finance (*Bundesministerium der Finanzen*, BMF) has now expressed its view on this in administrative guidance from 25.10.2013.

The new legal situation provides for the billing document to include the mandatory designation of the German term *Gutschrift* (self-billed invoice) if a recipient of goods or services issues self-billed invoices for the goods or services received. However, instead of the term *"Gutschrift"*, other designations for the German term *"Gutschrift"* in the official EU languages may also be used.

A distinction has to be made between the VAT term *Gutschrift* (i.e. self-billed invoice) and the other definition of *Gutschrift*, which in German is also generally used to mean a cancellation or a correction of an original invoice (in commercial practice this is known as kaufmännische *Gutschrift* a so-called credit note). However, in this respect, the tax authorities have now clarified that the use of the term Gutschrift in the case of, e.g. returned goods or a cancellation, where the term *Gutschrift* does not pertain to VAT, will not be of relevance in terms of VAT. Previously, to a certain extent, it was feared that, in such a particular instance, the recipient of such a statement would be liable for the VAT charged (cf. issue 7-8/2013) – this will not be the case.

Recommendation: Thus, the BMF circular simplifies the implementation of cancellations and corrections previously designated in German as *"Gutschriften"* (credit notes), insofar as established operational processes pertaining to credit notes do not have to be changed and the designation, in German, of a cancellation or a correction as a *Gutschrift* will not be detrimental from a VAT point of view.

More Information: The above-mentioned BMF circular, from 25.10.2013, can be downloaded at any time at www.bundesfinanzministerium.de (German version only). Furthermore, it deals with:

- the law applicable to the issue of invoices,
- the date of the issue of an invoice,
- the statement "reverse charge" and
- statements on invoices in exceptional cases.

Moreover, the BMF statement includes a transition period, until 31.12.2013, during which no complaints shall be made if the term *"Gutschrift"* or any of the other mandatory items of information on an invoice are omitted.

Taxation on earnings at international commercial partnerships – Changes to guidelines in sight?

Who for: German domestic commercial partnerships with foreign sources of income and/or foreign shareholders as well as reverse set-ups – in each case together with their shareholders.

Issue: Commercial partnerships, at least in Germany, are a frequently used legal form. However, the taxation of their earnings or of those of their shareholders is frequently fraught with problems if the company has foreign sources of income and/or if shareholders live outside of Germany and double taxation treaties (DTTs) exist between the states involved. Conversely, this also applies to foreign (non-German) commercial partnerships with German sources of income and/or German shareholders. Here, in each case, disputable tax issues include both on-going taxation as well as aperiodic events (for example, if shareholders move away from Germany to a foreign country, please see issue 11/2013). A problematic issue here, up to now, from the point of view of the taxpayer, was that the courts and the tax authorities, to some extent, held opposing views.

However, now, a recent Federal Ministry of Finance (*Bundesministerium der Finanzen*, BMF) draft circular on the application of DTTs to commercial partnerships has raised the expectation that, in some areas, the authorities

would like to depart from their previous views. Thus, the BMF draft no longer assumes that, even under the terms of tax treaties, partnerships deemed to be commercial under German tax law, or property companies as part of a corporate demerger generate or transfer business profits. At the same time, it is also no longer assumed that, under the terms of tax treaties, the income of a commercial partnership that, at least, also engages in business operations, generally represents business profits.

» **Recommendation:** Depending on the individual case, the consequences of the shift in the opinion of the authorities could be both favourable as well as detrimental. Therefore, commercial partnerships, with an international group of shareholders or foreign sources of income, and their shareholders would be well advised to contact their PKF consultants, in good time, in order to conduct a detailed review of the consequences. This is all the more important, as in the BMF draft there are plans to make the new opinions applicable to all cases that are still open – retroactively, too.

» **More Information:** The draft of the new BMF circular, of 5.11.2013, can be found online at www.bundesfinanzministerium.de (German version only). In particular, the draft will replace the currently applicable BMF circular, of 16.4.2010 (German Federal Tax Gazette – *Bundessteuerblatt*, BStBl. I 2010 – p. 354).

Personal Taxes

A second home or a holiday home is not a so-called family residence for the purposes of gift tax

» **Who for:** Married taxpayers who use a second home or a holiday home privately and who would like to transfer it to their spouses by way of gifting.

Issue: Under gift tax law, the transfer of domestic (German) owner-used residential property between spouses is tax-free if the property in question is the so-called "family residence" that forms the focal point of family life.

Recently, in a case related to the gifting of a semi-detached house in Sylt (an island in Northern Germany), the Federal Fiscal Court (*Bundesfinanzhof*, BFH) ruled that second homes or holiday homes could not be classified as belonging to the "inner" core of a marital and economic union and, therefore, cannot be deemed to be a family residence within the above meaning. The BFH explained this strict interpretation of the term "family residence" by arguing that favourable treatment for all owner-used houses and owned dwellings would not be compatible with the general principle of equality. In the case in question, the fact that, over the course of a year, the property on Sylt was used not only for recreational purposes but, instead, also for business was not relevant against the background that the second home was, nonetheless, still only used from time to time.

» **Recommendation:** The transfer of properties, used as private residences, between spouses is still subject to favourable treatment within the scope of the inheritance tax-free allowance of € 500,000, but this would also reduce it accordingly.

» **More Information:** The BFH ruling of 18.7.2013 (case reference: II R 35/11) can be downloaded at www.bundesfinanzhof.de (German version only).

Broader recognition of employment contracts with relatives

» **Who for:** Taxpayers who employ close relatives.

» **Issue:** The recognition of employment contracts with relatives is a, so-called, long-running issue that the Federal Fiscal Court (*Bundesfinanzhof*, BFH) has to deal with over and over again. Recently, it had to rule on a case where a taxpayer was running an advertising agency as a sole trader and had concluded employment contracts with his parents for the provision, of 10 respectively 20 hours office services per week. The local tax office did not recognise the business expenses attributable to this based on the argument that the parents had worked longer than the contractually agreed weekly hours and, furthermore, no records had been kept of the hours worked.

The BFH ruled in favour of the taxpayer on the basis that overtime did not constitute non-compliance what was actually agreed. Rather, the principal contractual performance indeed remained unaffected by the unpaid overtime. The BFH was also of the opinion that time sheets were not necessary. As a rule, failure to keep time sheets does not have an impact on the issue of the arm's length nature of the working conditions. Here, it was rather a case of providing evidence of whether or not the contractually agreed scope of the work was actually done, which was undisputed in the above-mentioned case.

» **Recommendation:** In the view of the BFH, an external comparison may be carried out less strictly in cases

where the taxpayer would have had to hire a third-party instead of his/her relatives. Therefore, before concluding a contract with relatives it should be ensured, as far as possible, that a relative is not being hired to perform work that the business owner would normally do him/herself.

» **More Information:** The above-mentioned BFH ruling of 17.7.2013 (case reference: X R 31/12) can be found online at www.bundesfinanzhof.de (German versions only).

ACCOUNTING

Simplifications under the German Accounting Amendments for Micro-entities Act – Exercising these options requires disclosures at the foot of the balance sheet

» **Who for:** Corporations and commercial partnerships without any fully liable natural persons (e. g. a GmbH & Co. KG a German limited commercial partnership) that remain below certain thresholds.

» **Issue:** For so-called micro-entities, simplifications with respect to accounting and disclosure will apply to the annual financial statements for financial years ending after the 30.12.2012 (cf. the relevant previous report in issue 01/2013). Micro-entities are companies that do not exceed two of the following thresholds on two consecutive reporting dates:

- revenues: € 700,000
- total assets: € 350,000
- max. annual average number of 10 employees

Moreover, micro-entities are no longer obliged to prepare notes to the accounts. However, the following disclosures have to be made at the foot of the balance sheet:

- contingent liabilities, which do not have to be shown in the balance sheet, in accordance with Sections 251 and 268 para 7 of the German Commercial Code (guarantees etc.);
- advances and loans granted to members of the management board, of the supervisory board or an advisory board;
- holding of own shares.

If the notes to the accounts are omitted, then information that may be disclosed in either the balance sheet or the P&L or else in the notes to the accounts has to appear in either the balance sheet or the P&L. If an abridged annual financial statement is drawn up, then explanatory information is only required for the items that have been reported there. However, it is not possible to omit information about liabilities with a residual time to maturity of up to one year, nor information relating to arrangements under company law (loans, receivables and liabilities owed to the shareholders of a GmbH, etc.).

» **Recommendation:** If managing directors decide to continue drawing up the annual financial statement in accordance with general provisions, irrespective of this, it will still be possible to make use of the simplifications for the published version of the statement.

Managing shareholder settlement accounts could require compliance with the provisions of the German Banking Act (KWG)

» **Who for:** Companies that manage settlement accounts or private accounts for their shareholders, or such ones to which non-personally liable shareholders make loans.

» **Issue:** It is common practice for a company to manage settlement accounts for its shareholders, in which profits are retained or withdrawals are offset. However, recently, the Federal Court of Justice (*Bundesgerichtshof*, BGH) ruled that, under certain conditions, a claim for damages could arise against the persons/bodies acting for the company (legal representatives, supervisory bodies) as a result of the management of the accounts. Namely, this could be the case if such settlement accounts do not properly present the nature of a liability reported on an appointed date – equity (subordinated) or debt. This is because accounts that are not explicitly designated as being equity capital could fall within the provisions of the German Banking Act (*Kreditwesengesetz*, KWG).

The background is that, in this connection, under certain circumstances regulated by the KWG, a company requires written authorisation from the German Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, BaFin) to engage in banking transactions. Put more simply, this is the case when total deposits of more than five individual deposits exceed € 12,500, or if there are more than 25 individual deposits (irrespective of total deposits). If the required authorisation has not been granted, then the persons/ bodies acting for the company will be liable

for damages if the repayment of these deposits is not possible – for example, in the case of the company's insolvency.

In its ruling of 19.3.2013, the BGH has now decided that these rules shall also apply to funds in shareholder settlement accounts. Likewise, in many cases, it is likely that freely available funds in private accounts will fall within the scope of deposit-taking that requires authorisation; ultimately, this will also apply to shareholder loans from non-personally liable shareholders.

» **Recommendation:** Insofar as, in accordance with the above-mentioned regulations, your company engages in deposit-taking that, in principle, requires authorisation, you should check as to what extent the obligation to seek permission does not apply on account of special exemptions. Here, the following could be taken into consideration, in particular, an agreement on guarantees in accordance with standard banking practice, which could satisfy a creditor directly, or an agreement for qualified withdrawals. For detailed advice please do not hesitate to contact your PKF consultant.

» **More Information:** The BGH ruling of 19.3.2013 (case reference: VI ZR 56/12) can be found online at www.bundesgerichtshof.de (German versions only). Furthermore, the BaFin has issued a fact sheet *"Hinweise zum Tatbestand des Einlagengeschäfts"* ("Indications which point to of deposit-taking"), which can be downloaded at www.bafin.de. The extent to which, in the absence of a BaFin licence, an auditor of annual accounts has to state in his report that there has been an infringement is currently under discussion at the Institute of Public Auditors in Germany (*Institut der Wirtschaftsprüfer*, IDW).

LEGAL

Options for organising works council elections

» **Who for:** Employers and employees.

» **Issue:** When considering the options regarding the organisation of works council elections, the relevant organisational unit is the enterprise for which the respective works council is in principle to be elected. Building on this organisational unit, employers and employees have a variety of choices that facilitate the setting up and cooperating with the works council.

(1) Companies with several operating units – In such companies, a company-wide works council may be set under a collective agreement, or in the case of employers not bound by a collective agreement, under a works agreement. In companies with very many operating units it is possible to group the individual units together by regions. This could be useful for employers who have, e.g. branch operations. Furthermore, companies that organise their business units along product or project lines can set up so-called divisional works councils.

(2) Setting up subsidiary parts of a business – There could also be room for manoeuvre when non-independent subsidiaries of a business are set up. Under certain statutory conditions, provision is made for a separate works council to be elected even though no standalone operating unit actually exists. In order to avoid this, ahead of the new structure, you can ensure that, for example, the non-independent subsidiaries of the business are not set up on a standalone basis in terms of their scope of functions and organisation.

(3) Size of the works council – The number of works council members that are to be elected is based on so-called thresholds, i.e. on the number of employees usually working in an establishment who are entitled to vote, with the exception of the executive staff. However, in view of a Federal Labour Court (*Bundesarbeitsgericht*, BAG) ruling (case reference: 7 ABR 69/11), contrary to the previous opinion, temporary workers also have to be included in this number by the company that employs them. The more staff a business employs, the bigger the works council committee and the number of works council members who have to be released to serve on it, have to be.

» **Recommendation:** If, in the run up to elections, it becomes clear that there is a difference of opinion between the employer and the works council on the issue of which organisational unit should act as a basis, it is advisable to initiate status proceedings in court so that the issue can be bindingly resolved.

» **More Information:** You can read about the main aspects that should be taken into consideration when preparing and conducting works council elections in issue 11/2013. In the next issue we will be discussing possible reactions to errors in the electoral process.

Companies that advertise are required to state their legal form

Who for: Companies that advertise.

Issue: A retailer published price information in an advertising supplement in a newspaper but, in the course of this, had omitted to give its legal form (e. K. = *eingetragener Kaufmann*, or registered trader). Subsequently, the *"Verein gegen Unwesen in Handel und Gewerbe"* (The Society for the prevention of detrimental behaviour in trade and commerce) brought an action against the retailer for failing to do so.

The Federal Court of Justice (*Bundesgerichtshof*, BGH), in the last instance, upheld the complaint and accepted that Section 5a of the German law against unfair competition had been infringed. According to this, anyone who withholds relevant information from the consumer acts in a way that is unfair. The key aspect in this particular case was that the goods were actually offered, with reference made to their features and price, so that an average consumer would have been able to decide to carry out a business transaction. In this case, the identity and the address of the advertising company was relevant information and should also have been provided. Information about identity, in turn, requires an indication of the legal form, as this is an integral part of the firm and the trade name of the company, as the BGH has now made unmistakeably clear. The ruling applies not only to advertising supplements but, indeed, concerns all types of print and other forms of advertising for products and services.

Recommendation: In order to avoid expensive warnings, it is recommended that, in principle, before the start of an advertising campaign, the possible legal challenges should be checked and, in particular, any infringements of competition law.

More Information: The full version of the BGH ruling, of 18.4.2013, (case reference: I ZR 180/12) was published online at www.bundesgerichtshof.de (German version only).

CORPORATE FINANCE

Independent Business Review – Strengthens negotiation position with capital providers

Who for: Companies that have decisions pending regarding their capital funding (new loans, prolongation of existing loans, adjustment of terms).

Issue: Before the prolongation of existing facilities or the provision of additional capital, the company seeking finance has to convince (potential) capital providers that it will be worth their while to supply the necessary capital. In this respect, a practical instrument is the commissioning of a so-called Independent Business Review (abbreviated to IBR). As part of an IBR, a detailed analysis is performed of a company's past as well as its future financial and operational situation in order to provide current and new capital providers with a sound data basis for their pending investment decisions. This includes specifically:

(1) Analytical focus as part of the IBR process – In principle, an IBR is a standardised process for the analysis of a company in which, nevertheless, company-specific aspects of a company's situation and/or the reason for the review are accentuated. As part of the IBR, typically, the following topics are given priority:

- a company's business model and the identification of key value and cost drivers;
- the current financial situation in connection with a detailed assessment of the financial position, cash flows and results of operations derived from developments in the past.
- a projection of the current situation in the company's market and competitive environment in conjunction with an analysis of strengths and weaknesses (SWOT analysis);
- a plausibility check of the financial planning assumptions based on the insights gained from the previous steps in the analysis and the underlying corporate strategy;
- a scenario/sensitivity analysis, in particular, in respect of future cash flows and liquidity status;
- legal and tax frameworks.

(2) External evaluation of the results of the analysis – Based on the results of the individual analysis modules it is possible to identify optimisation potentials and alternative courses of action for a company's management. With the written report about the IBR, a comprehensive overall picture of the company emerges for (potential) capital providers and, at the same time, gives them an instrument with which they can monitor their commitment, in the future, by comparing it with the information, regularly made available by the borrower, about the economic development of the company.

(3) Internal results – options for action – For a company that is looking for capital funding, the result of an IBR is the availability of integrated financial forecasts that have undergone a plausibility check and are linked to both the strategic plan and also to operating working capital management. By identifying the key value and cost drivers, the options for action can be compiled, their impact on the financial position, cash flows and results of operations ascertained in detail and, once the capital funding has been provided, monitored. Furthermore, within the scope of a "follow-up", the borrower has the possibility of further improving its rating with the capital providers. In this case, the focus will be the implementation of the optimisation potentials that have been identified.

» **Recommendation:** It is likely that the phasing-in of new provisions for the extension of loans by banks ("Basel III"), as of 2014, will increase the importance of transparent and proactive communication on the part of companies looking for capital funding vis à vis capital providers. In order to guarantee this transparency in relation to operational and financial parameters, the IBR offers a particularly suitable basis. In the course of this, in order to ensure the credibility of the results of the analysis, it is recommended to engage an independent third party expert, to perform the IBR, who is accepted among the group of (potential) capital providers.

IN BRIEF

New payroll tax cash equivalents of the monetary advantage arising from free or reduced price meals

The above-mentioned values were fixed for 2014 in a Federal Ministry of Finance (B*undesministerium der Finanzen*, BMF) circular, of 12.11.2013, at € 3.00 for a lunch or a dinner and € 1.63 for a breakfast.

AND FINALLY…

"Anyone who has to transfer more than half of his/her income to the local tax office will be more anxious to save taxes rather than to earn money."

Hans-Karl Schneider (*1920), German national economist, 1985 – 92, Chairman of the Council of Experts

Impressum

PKF Deutschland GmbH Wirtschaftsprüfungsgesellschaft

Jungfernstieg 7 | 20354 Hamburg | Tel. +49 40 35552-0 | Fax +49 (0) 40 355 52-222 | www.pkf.de

until autumn 2014: An der Alster 42 | 20099 Hamburg

Please send any enquiries and comments to: pkf-nachrichten@pkf.de