Accountants & business advisers

PKF newsletter 04|14

Editorial

Dear Readers,

In an age of increasing globalisation with both people and their assets moving around, it's especially important for personal estate planning purposes to know, which inheritance laws will eventually apply. In this respect, from August next year, the European Succession Directive will bring about significant changes. These regulations, which aim to harmonise the existing regulations, will affect all cross-border succession cases and could entail a need for action or amendments with respect to testamentary arrangements or succession agreements. In our Focus section, you can read about all the important aspects of this issue.

In the course of the various amendments to the German Tax Law on Travel Expenses, there has been somewhat less focus on the changes in the area of rules about allowances for maintaining two households. We would like to draw your attention to important changes in that respect according to which there is now a requirement for a financial contribution if the own household is in the parental home (or that of the life partner). You can read about the details of the changes in our article on p. 4.

In the Accounting section, besides the next article in our series on the preparation of financial statements for companies in insolvency, you will find an „all clear" notice for commercial partnerships with shareholder settlement accounts. The confusion triggered by a ruling relating to the existence of a potential requirement for authorisation in accordance with the German banking act („KWG") has been eliminated by a recent statement from BaFin (the German Federal Financial Services Supervisory Authority). According to this, these settlement accounts will not normally fall within the scope of deposit-taking as defined in the „KWG" (more on this on p. 5).

Yours sincerely,
Your PKF Team

Contents

FOCUS

New inheritance law – What will be the effects of the European Succession Directive?

Increasingly, German testators are also bequeathing assets in foreign countries (e.g. property). Currently, there is no international inheritance law that governs the execution of cross border bequests. In view of the different inheritance laws of the Member States, settling a succession with an international dimension is usually complicated, protracted and expensive. It is estimated that, in Germany, there are around 500,000 cases with an international dimension and the assets in question amount to more than € 100 bn. The European Succession Directive should simplify the settlement of these cases from 17.8.2015.

I. Current legal situation is associated with the problem of the application of the scission principle

Under German law, succession matters are subject to the law of the state of which the testator was a national at the time of death. If the testator was German, then German inheritance law applies.

International succession matters are problematic if, e.g. a German national owns property in a foreign country, for example, in Spain or France. In Spain, the applicable law in the succession case would be German, even with respect to the property in Spain. However, under French law, the applicable law is the one where the property is located, hence, for a property in France it would be French law. However, a testator's assets in Germany and his moveable assets in France, e.g. the furniture in a property, will be bequeathed in accordance with German law. This results in the application of the scission principle with the consequence that for some of the bequeathed assets different statutory provisions related to succession apply, as well as different entitlements to a statutory compulsory portion and/or compulsory rights to inheritance. In future, the EU succession directive will seek to avoid the application of the scission principle.

II. Changes arising out of the EU Succession Directive

From 17.8.2015, the new Succession Directive will apply to succession cases throughout the EU (with the exception of the UK, Ireland and Denmark). Regulations that, up to now, have stipulated that a testator's nationality and the place where his/her assets are located shall determine the applicable succession law will be eliminated. The entire execution of a succession will then be subject to the law of the state in which the testator was most recently ordinarily resident at the time of his/her death.

» **For example:** If, say, at retirement, a German national moves from Berlin to Mallorca. He lives there happily for a number of years and dies in 2016. The rules of law applicable to the succession case will be those of Spain. This can have thoroughly undesirable consequences, in particular, for a surviving spouse who, according to German law, would be included among the group of legal heirs. However, according to Spanish law, a spouse would only be a legal heir in cases where there are no descendants or ancestors of the testator.

Yet, it is not always so simple to determine where the testator had been ordinarily resident. For example, what would be the case if the pensioner had only lived in Spain during the winter months? In principle, the habitual abode is relevant, thus, based on an overall assessment of the circumstances, the place that is the focus of family and social connections. As a rule, stays abroad that are purely professionally motivated are not deemed to result in ordinary residence within the meaning of inheritance laws. However, the related potential uncertainty with respect to the applicable law can be avoided.

- For example, testators are able to choose the law of the state of which they are nationals as the relevant applicable succession law.
- People with several nationalities may select the law of one of these states.
- However, the law of the state of ordinary residence may not be selected.

The choice of relevant law can be laid down in a handwritten or notarial will or a succession agreement. Nevertheless, it will only pertain to civil law and not to the applicable inheritance tax laws and the associated tax allowances.

III. Simplifications through a certificate of succession

In Germany, a certificate of inheritance provides documentary evidence of succession. This proof of status

of the heirs has also been introduced across Europe. A European Certificate of Succession will be implemented along with the European Succession Directive. In future, this will make it easier to provide documentary evidence of the status of heirs in foreign countries, as it will be recognised in all the member states. This will not replace the German certificate of inheritance and, moreover, it will not be mandatory to have this certificate issued. Rather, the European Certificate of Succession will be another possibility for providing proof of inheritance.

» **Recommendation:** Therefore, before the new legal provisions come into effect, on 17.8.2015, existing wills and other testamentary dispositions should be reviewed in order to check whether or not the choice of an applicable law, pursuant to the European Succession Directive, would be appropriate. Viable estate planning is only possible if it has been established which law would be applicable in the subsequent inheritance case. If you are uncertain as to what the impact of the new regulations will be in your case, or if you have other questions realted to your estate planning, please do not hesitate to contact your local PKF expert consultant.

TAX

Corporate Taxes

Taxation of free-float dividends in the case of additional purchases of shares during the course of the year – Doubts about the restrictive interpretation of the law by the German tax authorities

» **Who for:** Corporations that receive dividends from shareholdings in other companies.

» **Issue:** Dividends from shareholdings of less than 10 % (holdings in the shares that are freely traded) received after 28.2.2013 are generally subject to tax (cf. Focus article in issue 05/2013). In principle, the cut-off date for assessing the 10 % limit is the start of the calendar year, although a shareholding of at least 10 % that is bought during the course of the year is treated as if it had been acquired at the start of the year. However, according to a recent decree from the tax authorities, this assumed retroactive application only comes into effect in the case of a purchase of a stake of 10 % or more in a single acquisition transaction.

If an existing holding in shares that are freely traded is increased by an additional purchase of a stake of at least 10 %, then this will still be deemed to be a holding in the shares that are freely traded for that calendar year. Moreover, the retroactive application will not take effect if, in the current calendar year, stakes of less than 10 % each are acquired in different transactions but, overall, the 10 % limit is achieved.

» **Recommendation:** It would appear doubtful that the very restrictive interpretation of the tax authorities will withstand the scrutiny of the fiscal courts. In particular, in our opinion, a pro rata tax exemption only for dividends in the case of an acquisition of a 10 % shareholding cannot be derived from the wording of the legal provision. In view of the fact that the legal uncertainty still exists, any cases that are affected by this should be held open.

» **More Information:** Upon request, we would be happy to provide you with the decree of the Frankfurt/Main regional tax office, which was coordinated with the highest national tax authority and those of the *Länder* (Federal States), from 2.12.2013, to regulate Section 8b (4) of the German Corporation Tax Act (German version only).

Update on VAT pre-financing in the case of longer warranty periods

» **Who for:** Businesses that grant their customers a contractual right to withhold full payment (as security).

» **Issue:** Regarding valued added tax, businesses have to pay tax on their supplies already during the VAT accounting period in which the supply is made. This applies even if they have not yet received payment for this from their customers. In particular, building contractors often bear the risk to pre-finance the VAT, as they only receive the full payment for their supply in a later VAT accounting period.

It is only in the case of tax accounting on a cash receipts basis that this system for calculating VAT does not apply. With the system based on cash receipts, value added tax only has to be transferred at the point in time when the payment is received and thus the disadvantages for liquidity are avoided from the outset. However, only small businesses with annual turnover of below € 500,000, or freelancers who do not keep accounts, are entitled to calculate VAT on the basis of actual cash receipts.

Now, the Federal Fiscal Court (*Bundesfinanzhof*, BFH) in a recent ruling, has decided that, in future, building contractors with longer warranty periods and whose customers have a contractually agreed right to withhold full pay-

ment (for security), will not have to pay the full amount of value added tax (for a tax accounting period) to the local tax office. In future, if customers exercise their right to withhold full payment (as a security), the building contractor will only have to submit a payment for the amount of value added tax that is actually received. If a customer withholds full payment (as a security), in terms of VAT, this constitutes a reduction of the consideration so that the result is that the balance of the amount no longer has to be pre-financed.

» **Recommendation:** Up to now, the tax authorities have not stated whether or not they intend to follow this ruling. In cases that are affected by this, we recommend declaring the full amount of the remuneration and lodging an objection with regard to the advance VAT return with reference to the amended BFH ruling.

» **More Information:** The BFH ruling of 24.10.2013 (case reference: V R 31/12) can be found on the BFH website at www.bundesfinanzhof.de (German version only).

Personal Taxes

Employer-paid subsidies for foreign health insurance are tax-exempt after all

» **Who for:** Employers whose employees are members of a foreign statutory health insurance scheme.

» **Issue:** In a ruling from 12.01.2011, the Federal Fiscal Court (*Bundesfinanzhof*, BFH) decided that subsidies paid by a German domestic employer to an employee for his/her foreign statutory health insurance are taxable. Here, tax exemption for health insurance premiums does not apply as, in this case, the employer is not legally obliged to pay the subsidy (a precondition for the tax-exemption).

Now, in its circular from 30.1.2014, the Federal Ministry of Finance (*Bundesministerium der Finanzen*, BMF) has published a nonapplication decree relating to this ruling, which is favourable for the taxpayer. According to this, the subsidies paid by a German domestic employer to an employee for his/her insurance cover in a foreign statutory health insurance scheme will be exempted from income tax, at least, within the EU, EEA and in relation to Switzerland.

The aforementioned ruling will not be applied on account of an objection raised by the Federal Ministries of Health as well as of Labour and Social Affairs. Contrary to the view of the fiscal courts, the Ministries believe that, under social security law, employers are obliged to pay subsidies. Voluntary membership of a statutory health insurance scheme in the EU, the EEA and Switzerland now has the equivalent status of (voluntary) membership of a German domestic statutory health insurance scheme.

» **Recommendation:** The BFH ruling is no longer generally applicable. Tax exemption for premiums paid to foreign statutory health insurance schemes is applicable to cases that are still open.

Maintaining two households in the case of a joint household with parents – A financial contribution is required

» **Who for:** Employees who live with their parents and have a second home in their primary workplace location.

» **Issue:** An employee is deemed to be maintaining two households if s/he is employed outside of the place in which s/he maintains an own household (= primary household in the habitual abode), and also lives in the workplace location. Since the beginning of the year, there has been a legal definition for the German term *"eigener Hausstand"* (own household), which up to now had been interpreted by case law. From now on, the following indicators apply when determining whether or not an own household exists: besides occupying a dwelling, an appropriate financial contribution has to be made to the living costs. In future, the contribution to costs (e. g. rent, service charges, food costs) has to be proven.

Up to now, according to the case law, payment was merely an indicator of the existence of an own household and not a necessary prerequisite and, as a rule, it was assumed that an older, economically independent child had a determining influence on the running of the household. As of 2014, this view is now obsolete.

It is no longer considered sufficient if an insignificant amount of money is contributed to the costs of running the household. Those affected should contribute more than a share of 10 % of the regular monthly costs that are incurred.

» **Recommendation:** The previous case law should be applied up to 2013. From 2014 onwards, you should ensure that the amount of the financial contribution is at least equivalent to 10 % of the costs and that documentary proof of this is also available.

ACCOUNTING

Preparation of financial statements in insolvency – Part 2: financial accounting

» Who for: Companies that are facing insolvency, or that have become insolvent, as well as their representatives.

» Issue: During insolvency, a company, or an insolvency administrator still has to fulfil financial accounting obligations. In particular, these consist in maintaining and/or preparing:

- ledgers and an opening balance sheet account (potentially, together with the respective notes to the accounts),
- annual financial statements for the end of each financial year during the period of insolvency, as well as
- final accounts to complete the insolvency proceedings.

In principle, the regular disclosure and auditing obligations under commercial law are applicable in case of insolvency. Particular consideration should be given to the following aspects:

(1) Financial years – The last financial year of the operating company ends on the day before insolvency proceedings are opened and, on the next day, the new financial year of the insolvent company begins. Usually, the last financial year of the operating company is a short financial year. As a rule, during insolvency, the financial years last for twelve months. Therefore, insofar as no shareholders' resolution is made to opt for another short financial year, after insolvency proceedings have opened, the rhythm of the financial years will generally differ from the one of the operating company. After the insolvency has been terminated, if the company continues to operate then the old regular cycle will be revived automatically. Therefore, another short financial year will be created up to the completion of the insolvency.

(2) Going-concern presumption – Usually, the question of whether or not the financial statements for the last (short) financial year before insolvency proceedings were opened, as well as for those during insolvency, can be prepared under the presumption that the company will be able to continue as a going concern will be of great importance. If this is not the case, then there will be numerous differences compared with the regular financial accounts (c.f. PKF Newsletter 4/2010).

(3) Notes to the opening balance sheet account – Corporations and commercial partnerships with the same status have to report particularities specific to insolvency with regard to this set of figures, the stage reached in the proceedings, as well as measures that have already been implemented and other planned measures.

» Recommendation: With respect to a potential obligation to audit the annual financial statement, simplifications are possible if the circumstances of the company in insolvency proceedings are easily understandable so that, as regards the interests of the creditors, an audit would not be necessary. In particular, this is possible towards the end of a liquidation, however, in the case of a going concern this is usually no longer an option.

» More Information: Information on the insolvency-specific preparation of financial statements during insolvency proceedings can be found in the accountancy notes of the IDW (IDW RH HFA 1.011). (IDW = *Institut der Wirtschaftsprüfer*, or The Institute of Public Auditors in Germany).

Shareholder settlement accounts – All-clear with respect to obligations that fall within the scope of the German Banking Act

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

» Issue: In the PKF Newsletter 12/2013, we informed you about the risks that could arise from a recent ruling of the Federal Court of Justice (*Bundesgerichtshof*, BGH) for a company that manages settlement accounts for its shareholders. The risk could be incurred by persons and/or bodies acting for a company (legal representatives, supervisory bodies), in relation to the actual management of the accounts. The risk could arise if the nature of a liability reported on an appointed date had not been presented clearly and unambiguously (as equity or debt). Debt could fall within the scope of the provisions of the German Banking Act (*Kreditwesengesetz*, KWG).

The German Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, BaFin) has now amended its fact sheet *"Hinweise zum Tatbestand des Einlagengeschäfts"* ("Indications which point to deposit-taking"), according to which debt falls within the scope of the provisions of the KWG only under certain additional conditions. Thus, a key condition is now that, in the event of a crisis (e. g. imminent liquid-

ity problems), a shareholder should not also be able to demand a payment from the settlement accounts, managed by the company that would thus bring about insolvency. The duty to refrain from this demand stems from the fiduciary duty of the shareholder, which is usually the case at commercial partnerships. The situation is different, in particular, in the case of a *Publikums-KG* (German public limited partnership) where, for the purposes of banking supervisory regulations, besides paid-in capital, any loans that are granted are usually treated as unconditionally repayable funds and, thus, qualify as deposit-taking within the meaning of the KWG.

» **Recommendation:** Now, in principle, if you manage shareholder settlement accounts you can save yourself the trouble of performing a detailed analysis in order to determine whether or not a deposit account has to be managed in accordance with Section 1 of the KWG. Nevertheless, one lesson that can be drawn from all the fuss is that monitoring balances and the terms and conditions between the company and the members for the purpose of preparing the annual financial statement helps to avoid risks, is sound practice and, moreover, serves to acknowledge mutual trust and loyalty.

» **More Information:** The above-mentioned fact sheet *"Hinweise zum Tatbestand des Einlagengeschäfts"* ("Indications which point to deposit-taking") is from 11.3.2014 and is available at www.bafin.de.

LEGAL

Transfers of shares in a GmbH (German limited liability company) - Foreign certification is still possible

» **Who for:** Holders of shares in a GmbH.

» **Issue:** The transfer of shares in a GmbH has to be certified by a notary in order to be effective. The associated fees for a German notary are regulated by law and are not negotiable. By contrast, foreign notaries are usually more flexible and frequently significantly less costly.

However when the Act for the Modernisation of Limited Liability Company Law (*Gesetz zur Modernisierung des GmbH-Rechts*, MoMiG) came into force, it was doubtful whether such foreign certification would be considered valid because a foreign notary is not obliged to file the amended shareholders list. In this respect, the Federal Court of Justice (*Bundesgerichtshof*, BGH) has now clarified that despite the lack of an obligation an entitlement to file the amended shareholders list nevertheless does exist and that the commercial register court shall accept this.

However, this is still on condition that the foreign certification can be considered to be equivalent to the German certification. This is the case if the foreign notary's training and position in legal life are equivalent to those of a German notary and if, for certification, the foreign notary is subject to procedural law that is comparable with the law in Germany.

Before MoMiG came into force, in 2008, the supreme court recognised that Swiss notaries fulfilled these conditions. While the case in question, once again, concerned a Swiss notary, unfortunately, the BGH did not expressly affirm this. Nevertheless, it is generally assumed that, in this case, the conditions for equivalence are still fulfilled.

» **More Information:** The BGH ruling, discussed above, from 17.12.2013 (case reference: II ZB 6/13) was published online at www.bundesgerichtshof.de (German only).

Internet subscription traps – BGH has ruled this to be attempted fraud

» **Who for:** Internet users who have been drawn into a so-called subscription trap or who could be drawn into one.

» **Issue:** The internet bustles with quite a few shady providers that operate websites that are subject to a charge, where the price for the services provided is not discernable at first sight and frequently can only be found in the "small print". Soon afterwards, the users who have been deceived in this way are faced with payment requests that are frequently followed by letters from lawyers and threats to transfer personal data to SCHUFA (a German credit rating agency). This was also the background to the case that the Federal Court of Justice (*Bundesgerichtshof*, BGH) recently ruled on. It was a case of indiscriminate use of an online route planning service that resulted in a 3-month subscription charge of around € 60.

Here, the BGH decided that this was a case of (attempted) fraud and the BGH ruling, from 5.3.2014, has established a principle. By deliberately concealing that a charge will be levied, the website has been designed specifically to deceive unalert or inexperienced users, which is why this constitutes an act of deception. Moreover, it was accepted that there had been a financial loss, which is a precondition for presuming that there was an intention to defraud, as the opportunity to use the route planner for 3-months had been practically of no value to the user.

Furthermore, in view of the fact that the BGH established that a punishable offence had been committed there was no entitlement to the payment under civil law.

» **Recommendation:** Those who are affected should not allow themselves to be put under pressure and payments should not be made under any circumstances. Nevertheless, you should still be very careful if you use any internet services where you are required to enter personal data.

» **More Information:** Furthermore, the so-called "button solution" has been in effect in Germany since 1.8.2012 (Section 312g German Civil Code). According to this, if an online order is submitted by a consumer then the obligation to pay has to be clearly and intelligibly highlighted. This clear indication of the obligation to pay has to appear if an order button is used.

CORPORATE FINANCE

Corporate financing by means of equity capital – Key points for an equity investment agreement

» **Who for:** Growth-oriented companies requiring financial resources, which traditional lenders are not able to provide, in order to implement their ideas or to achieve the necessary growth.

» **Issue:** Young companies, but also established companies that require fresh capital in order to finance larger, risky investments, are frequently dependent on alternative financing instruments such as equity capital.

Issue	Shareholder	Investor
Ability to influence decisions	Material decisions should be subject to the consent of the shareholders	Optimise in order to be able to have a determining influence on material decisions
Capital/Size of Shareholding	Give away as few shares as possible, however, the size of the shareholding should not be so small that the investor is not co-obligated	As high as possible but not too high so that the shareholders remain motivated
Capital Contribution	Immediate and in full	In phases, depending on performance

Tab. 1: . The opposing interests of the founder and the investor

If a company has identified potential investors and if the outcome of the subsequent due diligence by the investor was positive then, at the very latest, at that point negotiations will follow with the aim of concluding an equity investment agreement. In such an equity investment agreement, the founder and the investor specify the terms of the financing as well as other rights and obligations. The agreement effectively determines the "rules of the game" for the cooperation during the different business phases. For example, the agreement should include provisions that cover:

- the acquisition of the equity investment,
- the procedure during the period of the equity investment, as well as
- the termination of the equity investment.

Here, the equity investment agreement is based on the so-called pre-money valuation. This is the value that the investor and the shareholder of the company that is to be financed will have agreed on immediately prior to the provision of the capital. The size of the shareholding depends largely on the amount of capital required by the company, the enterprise value that the investor ascribes to the company and the extent to which the investor would like to exert influence over the equity investment. However, to some extent, the shareholders of the company that is to be financed and the investors have opposing interests, as can be seen in the comparison presented in Table 1.

Below we discuss four, particularly important, key elements of equity investment agreements, although this is by no means an exhaustive list.

(1) Provisions relating to milestones – If within the scope of the acquisition of an equity investment, the shareholder and the investor have diverging views on valuations then it is possible to make adjustments here subsequently. If the investor initially accepts an increased valuation, then the interests of the investor can be taken into consideration through provisions relating to milestones. In the event that certain milestones are not achieved (condition precedent) the investor would then, for example, receive additional shares. Provisions relating to milestones can also be agreed within the scope of paying out the capital resources. Payments are then linked to the achievement of certain corporate goals.

(2) Anti-dilution protection – There is considerable uncertainty regarding the company value, particularly, in the case of young companies in the early phase of

financing. If the company requires further capital after the equity financing and if, in the course of this, the company value is lower than previously assumed, then the investors that acquired an equity stake initially, on the basis of a higher valuation, would be disadvantaged. In order to reduce this risk, investors frequently insist on a provision according to which, subsequently, they are able to acquire further shares in the company at the nominal value.

(3) Scope of influence and rights to information – By agreeing on special rights to information that go beyond the legal requirements, the company will be obliged to provide the investors with extensive information about its business operations. If rights of consent are included in the equity investment agreement, then the company's management will only be able to transact certain business deals with the consent of the providers of the capital.

(4) Drag along and tag along rights – In equity investment agreements you will frequently find drag along and tag along provisions. Through this, an investor who is willing to sell can oblige the other shareholders to sell their shares to a third party at the same conditions, or in the event of a sale of the shares by the shareholders, the investor will have the option to transfer his shares at the same conditions.

» **Recommendation:** The above-mentioned aspects constitute only some of the possible provisions in an equity investment agreement. There are many different ways to structure an agreement and it can be very complicated and that is why adequate preparation is required. We would advise you to discuss these aspects, early on, with your consultant.

IN BRIEF

PKF VAT Issues with a focus on shareholdings

A new edition of VAT Issues was published in March, and is available for download at www.pkf.de. This edition focuses, in particular, on input tax deduction in the case of the acquisition, holding and disposal of shareholdings, VAT grouping and the contents of properly prepared invoices.

AND FINALLY…

„High taxes and surcharges turn wage increases into a hollow Easter egg."

Otto Kentzler (*1941), German businessman and former President of the German Confederation of Skilled Crafts

Impressum

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