PKF
Accountants &
business advisers

# PKF newsletter 03|16

## Editorial

Dear Readers,

In the last issue of our newsletter, in the first report of our two-part series on **customs law and customs clearance,** we focused on the import side. In this month's "Focus" section, we discuss customs audits for the purpose of export control. Timely preparation in the form of implementing audit-proof processes and internal controls is essential.

In our "Tax" section, we deal once again with **tax structuring** to avoid **double taxation when shareholders move to a foreign country.** While a new Federal Ministry of Finance circular is basically business-friendly, it nevertheless still leaves some questions unanswered and could also be violating EU law – not the amount of legal certainty you wish to have. By contrast, the **requirements for invoices where the input tax may be deducted** that were newly specified by the Federal Fiscal Court are not particularly business-friendly. Yet, the court has once again been accommodating to families with respect to **child benefit.**

From a commercial law perspective, the new legislation to **combat corruption** is significant as it broadens the concept of corruption to a large extent. In another contribution, we discuss a ruling by the Federal Court of Justice that goes beyond Germany's geographic frontiers and deals with the option of **opening insolvency proceedings** across borders.

Persistently low interest rates mean that those who prepare accounts according to German GAAP have to brace themselves for a few more years of increased pension provisions due to discount rates being driven down. The German government has now, at last, responded to this situation (albeit too late) and, consequently, there will be a lot of additional administrative effort and cost for companies.

In our "Corporate Finance" series, we provide you with four options, also available to medium-sized enterprises that enable continued access to **innovation** and make it possible to **promote and finance** it.

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

Yours sincerely,
Your PKF Team

## Contents

FOCUS

# Organisational recommendations with respect to customs law – Part B: Preparing for customs audits for the purpose of export control

In the last issue of our PKF newsletter, our recommendations with respect to the proof of origin of goods for the purpose of import control addressed the problem that there is not remotely any "equality of arms" between the customs authorities and companies. Following on from this, we now focus on exports. Businesses should carefully prepare for a customs audit, at the very latest, when the customs service gives notification of an audit. Moreover, businesses should also brace themselves for surprising enquiries. In the following section we outline the basic procedure for a customs audit and the possible focus areas of an export check.

## I. Reasons for a customs audit

There are many different reasons for a customs audit. In particular, they may arise from the German Fiscal Code, the Customs Code, the German Foreign Trade and Market Regulation Act as well as international treaties. In view of the wide range of obligations that could form the basis for a customs audit, companies should clarify, at an early stage, which rules and regulations they are obliged to follow (the focus here is compliance) and how they are able to prepare themselves for a customs audit. Infringements could have far reaching consequences, such as, e. g.

**Particular attention should be paid to the catalogue of dual-use goods.**

- the subsequent imposition of duties, or
- the loss of the advantages available under Authorised Economic Operator (AEO) status and the associated loss of important simplifications with respect to customs declarations that, to some extent, are essential for operations.

## II. Procedure for a customs audit

A customs audit is generally subject to the same national procedural law as an external tax audit. This is because procedural law, unlike substantive customs law, has not yet been harmonised throughout the EU. Therefore, in principle, the procedure for a customs audit is the same as the one for an external tax audit. The customs service will give notification of the audit, the period to be reviewed and the reason for the audit. However, in contrast with an external audit, greater significance is accorded to the documentation because, under customs law, many elements of a case will depend solely on the presence of the correct document. If customs auditors believe that companies have not complied with the rules then – depending on the seriousness of the violation – there is a risk of a warning, a demand for post-clearance recovery of the respective customs duties and, in extreme cases, administrative fines or prison sentences.

Furthermore, on the basis of an incorrect certificate of origin, compensation claims could arise from business partners, for example, should a partner receive a notice of subsequent recovery of duties from its national customs authority.

## III. Preferences audits

Customs audits can also be initiated in the interest of another state. In such a case, Germany, for example, could be requested to review the requirements for a facilitation of trade that has been agreed under international law. The latter applies especially in the case of so-called preferential agreements, which regulate import duty reductions, or even waivers between the states involved. Germany (as the exporting country) then has to check, in the interests of the importing country, whether or not the certificates of origin, which were issued by the domestic or intra-community businesses for the customs facilitation, are correct. Customs will carry out a detailed check as to whether or not the place of provenance of a

product was Germany or another EU member state. In order to be able to provide this proof, an organisation and its processes have to be set up in such a way so that the determination of the preference can be transparently documented.

» **Example:** If a company manufactures products from various individual components then documentary evidence has to be provided of the origin of all the components in order, ultimately, to be able to provide proof of the origin of the manufactured product. The purchasing, sales and bookkeeping departments should be involved in this process.

**IV. Foreign trade audits.**

Customs audits also cover increasingly the provisions of foreign trade law. This serves security interests and, in recent years, has been increasingly tightened up for the purpose of combating terrorism. The obligations include a reporting requirement with respect to payments abroad and disclosure obligations and/or requirements to obtain approvals for the export of particular goods.

This affects not only exports which are subject to a so-called embargo (such as, currently, exports to Russia, for example), or that fall under the War Weapons Control Act, but also the export of so-called dual-use goods. These are goods that, if appropriately applied, can be used for purposes that are contrary to the interests of the Federal Republic of Germany and/or the EU. Difficulties can arise here as, frequently, the possibility for improper use is not obvious.

» **Example:** If a diving boat with the relevant technical equipment (sonar, etc.) is supplied, for example, to a wind farm in the North Sea then it is necessary to check whether or not this export is notifiable and/or subject to approval. At first glance, the "possible incorrect use" is certainly not apparent in this case.

In-depth technical knowledge is required when checking to ascertain whether or not the goods that are to be exported appear in the list of goods in the very comprehensive appendices to the EC Dual-Use Regulation.

» **Recommendation:** In the event of a foreign trade audit, business owners should be able to demonstrate that they have set up their operational structures in accordance with regulatory compliance requirements. In general, already in the run-up to customs audits, all companies would be well advised to conduct a comprehensive analysis of the obligations that exist. In cases of infringement, obligations will have to be subsequently met, or at least, organisational measures, which will prevent such infringements from happening in the future, will have to be demonstrably taken. If consequences under criminal law are expected then the option of a voluntary self disclosure should be considered. Your PKF consultant would be very pleased to provide you with support when you are carrying out the analysis and setting up the processes and documentation as well as with any cases that require legal protection.

## TAX

### Restructuring within a group – The new Federal Ministry of Finance circular on Section 50i of the German Income Tax Act provides greater legal certainty

» **Who for:** Corporate groups that, in the interests of their shareholders, are planning restructuring with an international dimension.

» **Issue:** In the Focus section of the September 2015 edition of our newsletter, we discussed the issue of "Avoiding double taxation when shareholders internationalise" with reference to Section 50i of the German Income Tax Act, which was newly introduced in 2013. We pointed out that professional advice would be necessary in this respect. Ultimately, in cases where this section is applicable, this could result in real double taxation. This is due to the fact foreign countries can tax in accordance with DTA rules and Germany on the basis of Section 50i(1) of the German Income Tax Act. Possible restructuring configurations were suggested in order to avoid this. Nevertheless, at the same time, we drew attention to the risk associated with the recently introduced Section 50i(2) of the German Income Tax Act. Under this provision, it would only be possible to carry out the necessary restructuring by accepting the taxation of any existing hidden reserves.

An easing and/or restriction of Section 50i(2) of the German Income Tax Act to cases of misuse, as called for by many, has now been provided by the Federal Ministry of Finance (*Bundesministerium der Finanzen*, BMF) in its its circular of 21.12.2015. Through a so-called equitable measure, the way can now be paved for a tax-neutral restructuring, with the aim of avoiding double taxation. To this end, the transferring entity and the acquiring entity are both required to make identical requests concerning the non-application of Section 50i(2) of the German Income Tax Act. Furthermore,

the request shall only be deemed to be valid to the extent that the right of Germany to tax ongoing income, as well as gains from disposals and/or transfers, has not been excluded or restricted.

It will now indeed be possible to carry out a restructuring within a group with greater legal certainty. Nevertheless, a number of questions still remain open. For example, up to now, transfers for no consideration to benevolent trusts, or to family foundations have not been accorded privileges. Moreover, a violation of EU law could ensue as there is a differentiated assessment for domestic and foreign cases.

The BMF circular does not therefore provide a complete solution for these issues. It would appear that it will still be necessary to adapt legislation and, according to reports, this is also under discussion. It remains to be seen whether or not the German government will then remove all domestic cases from the scope of application of Section 50i(2) of the German Income Tax Act.

» **Recommendation:** For the time being, it will be possible to avoid double taxation in most domestic (German) cases. However, this means that the necessary structural adjustments should already be implemented before the potential foreign assignment of shareholders or even their move abroad. Our PKF experts would be pleased to help you in this regard.

## Issuing invoices – Is a P.O. Box a satisfactory address for a supplying company?

» **Who for:** Enterprises that issue and/or receive invoices that include value added tax.

» **Issue:** As is generally known, in order to be able to deduct input tax, a business owner has to have an invoice that complies with certain legal minimum information requirements as set out on Section 14(4) of the German VAT Act. The invoice has to show, among other things, the complete name and address of the supplying business as well as of the recipient of the goods or services. According to a Federal Fiscal Court (*Bundesfinanzhof, BFH*) ruling from 22.7.2015, in this case an address is defined as the one that existed at the point in time when the supply was made and the invoice issued and the one at which the supplying company also actually pursues its business activities. An address that merely guarantees that a company can be contacted there (a "post box address" or P.O. box) is not adequate.

In the case in question, the recipient of the invoice was not permitted to deduct the input tax from the invoices that had been received. The issuer of the invoices had given an address at which he was not pursuing any business activities (but instead simply where the accounting company engaged by him dealt with the correspondence). Moreover, the fact that the recipient did not know that the supplying company's address was incorrect did not change anything. The court argued that the recipient is under an obligation to assure her/himself that the information shown on an invoice is correct.

In any case, the tax authorities currently still have a different opinion with respect to providing a P.O. box number as an address and, for them, this is considered adequate (cf Section 14.5(2)(3) of the German VAT application decree). Moreover, there is currently another case pending at the BFH (case reference: V R 25/15) where, in the first instance, the Cologne tax court deemed an address at which no business activities were taking place to be adequate. The intention and the purpose is "solely" to clearly identify the (supplying) business. The ECJ used an argument that was similar in substance in its ruling from 22.10.2015 (case C-277/14).

» **Recommendation:** As fas as possible, business owners should check and potentially document that the address of the supplying business, as shown on the invoice, does indeed constitute the place of business and not merely a "post box address". However, it remains to be seen whether or not the BFH's restrictive interpretation will prevail in case law and in practice. If the other rulings are taken into consideration this appears to be rather doubtful. In any case, we will keep you informed in this respect and we will let you know in good time if a specific need for action becomes apparent.

» **More Information:** The full text of the BFH ruling (case reference: V R 23/14) is available at www.bundesfinanzhof.de (German version only).

## Child benefit – A master's degree can form a part of initial vocational training

» **Who for:** Parents of children who are studying.

» **Issue:** Child benefit may be claimed for adult children who are not yet 25 years of age insofar as they are still undergoing vocational training. After completing initial vocational training (e.g. also a course of study) child benefit may continue to be claimed only if the child is not employed for more than 20 hours per week on a regular basis.

Therefore, the Family Benefits Office *(Familienkasse)* refused to pay child benefit in a case where the child, after completing a course of study for a bachelor's degree in "business mathematics", had taken up a course of study for a master's degree in the same subject area and, additionally, worked as a student assistant (21.5 hours per week). The *Familienkasse* and the tax authorities viewed the initial vocational training as having been completed once the bachelor's degree had been attained.

In a ruling from 3.9.2015, the Federal Fiscal Court (*Bundesfinanzhof,* BFH) decided that this view was not correct. If the master's degree programme dovetails with the previous course of study for a bachelor's degree in terms of time and content and the professional goal that is aspired to can only be achieved after this advanced qualification has been attained then it forms part of the initial vocational training. In the case in question, these conditions were affirmed so that the employment was no longer of relevance.

» **Recommendation:** As the administrative instructions of the *Familienkasse* are based on different principles, in many cases it will be necessary to enforce the new case law by lodging an appeal. We would be pleased to provide you with support in this respect. Moreover, you should bear in mind that with regard to child benefit arrangements, the concept of initial vocational training is not the same as the one that is relevant for the deduction of (anticipated) work-related costs. In this respect, a differentiated approach is necessary.

» **More Information:** The BFH ruling with the case reference: VI R 9/15 can be found at www.bundesfinanzhof.de. (German version only).

# LEGAL

## New legislation to combat corruption

» **Who for:** Employers and employees who face the risk of being accused of corruption.

» **Issue:** Legislation to reform German criminal law on corruption came into force on 20.11.2015. In the course of the reform, according to the explanation of the Federal Ministry of Justice, international standards for combating corruption were transposed. Moreover, criminal liability loopholes have been closed and the range of punishable corruption offences within the scope of business dealings has been broadened. The corruption regulations from other laws have now been put together in the German Criminal Code. Previously, acts of bribery and corruption in business dealings were punishable if advantages were granted in return for unfair preferences. Now, it is not acts that involve competitive distortions that are punishable, but instead corrupt acts that lead to a violation of the duties of employees vis-à-vis their employers (the, so-called, principal-agent-model). This would be the case, for example, if employees violate their duties vis-à-vis their employers and, in exchange, they obtain an advantage from suppliers or service providers.

Extending the protective purpose to include the interests of employers, in some cases, has aroused strong criticism as, originally, it was only fair competition that was supposed to be protected. Provisions under civil law and employment law already cover an employer's financial interests to a sufficient degree.

» **Recommendation:** With an eye to the new criminal offences under the principal-agent-model, internal company guidelines and processes should now be reviewed so that employees are not exposed to any unnecessary criminal liability risks.

## Opening of insolvency proceedings in another EU member state – Recognition or presumption of bankruptcy tourism?

» **Who for:** Creditors and debtors involved in insolvency proceedings.

» **Issue:** In its ruling from10.9.2015, the Federal Court of Justice (*Bundesgerichtshof,* BGH) dealt with the recognition of the opening of insolvency proceedings in an EU member state. According to the previous rulings of German courts, the competence of courts in other member states with respect to opening proceedings can only


**Bankruptcy tourism is possible in certain cases**

be reviewed in exceptional cases. In view of the increase, in recent years, in "bankruptcy tourism", which is carried on in countries where there is a faster discharge from bankruptcy, the reviewability of the opening of proceedings has become significantly more relevant.

In the case under dispute, a claim was made against the defendant (D) – a business owner – as a guarantor. Subsequently, on the basis of an application that he had filed, insolvency proceedings were opened in England. With reference to the British insolvency proceedings, D opposed the claim, however, the Cologne Regional Court, as stated, ruled against him. The court viewed the move of D's habitual abode to England as being contrary to German public order. According to the Cologne Regional Court, D had moved his habitual abode solely for the purpose of evading the legitimate claims of his creditors. In the appeal, the BGH ruled in favour of D and the court was of the opinion that the opening of insolvency proceedings in a member state complies with the principle of mutual trust and should be recognised. A violation of German public order would only relevant in exceptional cases, for example, if the decision of the state where proceedings were opened constituted an unacceptable contradiction to the law of the German Federal Republic. This would only be the case if it was presumed that the decision of the court in the member state was arbitrary.

» **Please note:** Insofar as the habitual abode in another member state is not merely feigned, an application for the opening of insolvency proceedings may also be filed there.

# ACCOUNTING

## Pension provisions – Adjusting the imputed interest rate in accordance with Section 253(2) of the German Commercial Code

» **Who for:** Businesses that provide/have provided company pension schemes for their employees.

» **Issue:** There is still no end in sight to the sustained low interest rate phase. For companies this means that provisions will be driven up by the low interest rate environment. This will depress the net result and distort the presentation of the economic situation.

The German government is now counteracting these developments. Acting on a proposal by the German Federal Cabinet, on 18.2.2016, the *Bundestag* (lower house of the German parliament) passed the "Act implementing the residential mortgage credit directive and amending provisions under German commercial law." The act includes adjustments to Section 253 of the German Commercial Code (*Handelsgesetzbuch,* HGB). When determining the average interest rate for the valuation of pension provisions, the basis for this is no longer the last seven financial years but, instead, the last ten years. As a consequence, the adverse interest rate effect on companies from the ever lower average interest rates will be spread across more years.

Moreover, a new Section 253 paragraph 6 will be added to the HGB. According to this, the difference that results from calculating the average based on seven years and ten years has to be determined by the company every year and shown in the notes, or at the foot of the balance sheet. Furthermore, this amount of difference will not be available for profit distributions to shareholders. Thus, in future, companies will have to commission respective valuation reports on the basis of the old as well as the new approaches to determining average interest rates. Moreover, an annual (in some cases complex) reassessment will have to be performed of the amounts that are subject to a payout block.

The interest rate published by the *Bundesbank* (German Federal Bank) for the seven year average approach was 3.9 % as at 31.12.2015. The new ten year average interest rate is expected to be published soon.

» **Recommendation:** In principle, the new rules apply to financial years ending after the 31.12.2015. However, there is also the option of applying the rules retroactively for financial years beginning after 31.12.2014 and ending before 1.1.2016. It can be assumed that the new rules will formally come into force in March 2016 already. Therefore, businesses that prepare accounts should consider keeping their financial statements open until then in order to be certain that they are able to make use of the option to apply the new rules early.

# CORPORATE FINANCE

## Strategies for promoting and financing enterprise-wide innovation

» **Who for:** Business owners who wish to safeguard competitiveness by investing in innovation.

» **Issue:** Statistics show that innovative companies grow more quickly and generate a higher return on sales. Nev-

ertheless, according to studies by KfW (a German government-owned development bank) and the Association of German Chambers of Commerce and Industry (DIHK), the proportion of medium-sized enterprises described as being innovative is decreasing. This would suggest that medium-sized enterprises are increasingly ceding this domain to large companies. Yet, at a time when interest rates are at historically low levels and, frequently, there is excess cash, it is precisely the right time for medium-sized enterprises to invest in innovation. Here, the objectives are attractive returns and/or innovation for the future competitiveness and stability of the company. If innovation projects within the existing business structures are not feasible, there are alternative strategies for promoting and financing innovation, which are outlined in the following section.

**(1) Early-stage investments in startups via venture capital** – Venture capital is risk capital that is made available as equity to young innovative enterprises, usually at an early stage of their development. In return, capital providers receive shares in the company. In recent years, so-called corporate venture capital, where companies that are already established in the market make capital available, has gained considerably in importance. Many large companies invest in promising innovative enterprises, in some cases via subsidiaries specially set up for this purpose (e.g. BMW i Ventures). In the course of this, their aim is not solely to generate financial returns but also frequently to achieve strategic goals. Companies that, in this case, do not wish to act as capital providers themselves are able to invest in innovative startups via the respective venture capital funds. In doing so, there frequently is the advantage of diversifying their investment across several enterprises and, thus, reducing the risk of the investment turning into a complete failure. Other investors participate in such funds, although it is possible to contractually agree on a future purchase option, however. Given that this is an early-stage investment, this form of financing is particularly risky as, frequently, the startup is not yet ready to launch in the market.

**(2) Minority shareholding in/acquisition of an innovative startup** – A feasible alternative to venture capital is a minority shareholding in innovative startups that have already demonstrated that their products or services are ready for the market. In that alternative the advantage for medium-sized enterprises is that they are initially able to monitor the development of a business before investing. Likewise, they are more able to evaluate whether or not, from a strategic point of view, an investment is an attractive option. The investment made by EOS GmbH, the global 3D printing market leader, in DyeMansion, a Munich-based startup, can be mentioned by way of example for this model.

**It is never too early to start innovating**

**(3) Hiving off projects into special purpose vehicles** – Hiving off innovative projects into special purpose vehicles is an option in cases where, e.g. the existing corporate culture acts as a constraint on the development of ideas. By hiving off a business in this way, the company's management can create new specific structures that will exist regardless of the capacities and structures in the parent company and, thus, promote ideas and innovative strength. Furthermore, the company's management can freely decide

whether or not employees and assets should also be transferred into the newly founded special purpose vehicle in addition to capital. This form of promoting innovation can likewise help to reduce financial risk as, besides other strategic investors, financial investors can acquire a shareholding in the company, too. The risk of failure would thus be limited to the contributed capital as well as, possibly, the assets that were transferred.

**(4) Strategic partnerships and mentoring** – For companies that do not wish, or are unable to invest in other companies or funds, strategic partnership or appropriate mentoring initiatives also provide an opportunity to gain access, at any early stage, to company founders as well as their ideas and innovations. The startups, in turn, benefit in particular from the experience of and networking with medium-sized enterprises. Numerous initiatives here (such as, e. g. *"Mittelstand von heute plus Startups = Mittelstand von morgen"* [Today's SMEs plus startups = Tommorrow's SMEs] from the German Startups Association) provide support for establishing contacts. These could be relevant within the framework of a strategic partnership so that, ultimately, a win-win model can emerge.

» **Recommendation:** Businesses that would like to invest in innovation should also consider alternative funding strategies besides the company's internal investments in innovation projects. In this way, medium-sized enterprises are able to secure broader access to innovation.

# IN BRIEF

## Continuation of wage payments during sick leave – Supplements have to be included

Currently, within the scope of audits relating to social security regulations, to an increased extent, the focus of checks is whether or not the supplements that are normally granted (e. g. supplements for working on Sundays, public holidays and during the night shift) are also being included when wage payments continue to be made during sick leave. If this is not the case then the social security contributions relating to these supplements have subsequently to be paid. The amount that has to be paid subsequently is determined on the basis of the so-called claim principle (i. e. contributions accrue at the time when the employee generates a claim for remuneration). The companies concerned should review their payroll accounting practices.

# AND FINALLY…

"No such thing as no can do. But can't do it this way that's o.k."

**Artur Fischer, 31.12.1919 – 27.1.2016, German entrepreneur and one of the most prolific inventors of all time.**

**Impressum**

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14050 **Berlin** · Platanenallee 11 · Tel. +49 30 306 907-0
47059 **Duisburg** · Schifferstraße 210 · Tel. +49 203 30001-0
20354 **Hamburg** · Jungfernstieg 7 · Tel. +49 40 35552-0

39340 **Haldensleben** · Hagenstr. 38 · Tel. +49 3904 66 38-0
38350 **Helmstedt** · Bötticherstr. 51 · Tel. +49 5351 12 01-0
14476 **Potsdam** · Am Lehnitzsee 5 · Tel. +49 33208 223 55
56856 **Zell (Mosel)** · Schlossstraße 34 · Tel. +49 6542 96300-0

38122 **Braunschweig** · Theodor-Heuss-Str. 2 · Tel. +49 531 2403-0
60325 **Frankfurt** · Ulmenstr. 37-39 · Tel. +49 69 17 00 00-0
50670 **Köln** · Gereonstraße 34-36 · Tel. +49 221 1643-0

06114 **Halle** · Bernburger Straße 4 · Tel. +49 345 52 521-0
56410 **Montabaur** · Aubachstraße 13 · Tel. +49 2602 93 11-0
18055 **Rostock** · Am Vögenteich 26 · Tel. +49 381 491 24-0

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

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