PKF
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Editorial

Dear Readers,

After an uphill struggle, the German federal and state governments have agreed to amend the Inheritance Tax Act with effect from 1.7.2016. In the 'Focus' section you can read the new rules and decide for yourself whether it is appropriate to talk about an **inheritance tax reform**, or whether the least common denominator has been found. In any case, the judges at the Federal Constitutional Court still have to decide whether or not the new rules are now consistent with the constitution.

In the 'Tax' section, we have interpreted the most important **new rules with an international dimension** and which, in some cases, – according (now) to bad practice – again have to be taken into account retroactively. Two articles on current legal rulings then follow. One decision, which will be encouraging for businesses, concerns t**he retroactive correction of invoices**. In contrast, there was a less encouraging ruling for landlords who have **decorative repairs** carried out on newly acquired buildings.

The reports in the 'Legal' section discuss the rulings that reinforce the **right to information of a limited partner** as well as the rights of employees at the mere mention of the sensitive subject of **minimum remuneration**.

In the 'Accounting' section, for companies that have outsourced functions and services, we provide an overview about their monitoring obligations, particularly with respect to **IT security**, that have been developed by the Institute of Public Auditors in Germany (IDW) in the 'FAIT 5' standard.

When valuations are being carried out, the focus is frequently on corporate information. Under 'Corporate Finance' we discuss **country risks**, which should also be considered when developing fi nancial projections.

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

Your Team at
PKF

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FOCUS

Inheritance tax reform 4.0 – A difficult legacy

On 8.7.2015, the German government presented its 'Draft of an act to amend inheritance tax and gift tax law in accordance with the ruling of the Federal Constitutional Court'. More than 14 months elapsed before the Bundestag (lower house of German parliament) gave its approval, on 29.9.2016, following the involvement of the Mediation Committee and, on 14.10.2016, the Bundesrat (upper house of the German parliament) gave its approval. It remains to be seen whether or not this new law will now be judged to be constitutional. In any case, many legal heirs should reconcile themselves to the prospect of higher tax charges. Nevertheless, there will also be winners.

I. Scope of non-operating assets

When the various drafts that appeared in the course of the legislative procedure are compared it becomes apparent that certain points do indeed differ greatly from each other. This was probably due to the conflicting interests of the groups involved. This is most evident in the definition of non-operating assets. While the governmental draft still included a plan for a complete revision here, this is now no longer the case. The distinction between assets that qualify for tax relief and assets that are 'harmful' (detrimental from a tax point of view) has remained. The latter has been more broadly defined and now includes property that a third party is permitted to use, a 25 % shareholding in a corporation, works of art and securities as well as financial resources that, after liabilities have been deducted, exceed 15 % of the enterprise value. Under the old legal situation, the limit here was 20 %.

By contrast, from now on, tax privileges will be accorded to assets held exclusively for the purpose of meeting liabilities arising out of pension plan obligations and to which all other creditors, who do not have a direct entitlement under the pension plan obligations, do not have access.

Furthermore, third country investments of a holding company will continue to enjoy tax privileges. The newly inserted investment clause will probably be impractical. In this case, non-operating assets that, according to the will of the testator, will be used for investments in the company within two years after his/her death will likewise be accorded tax privileges.

II. Criteria for assessing relief

Unlike under the old legal situation, from now on, non-operating assets will no longer be regarded as the test for relief (all-or-nothing principle) but rather, as non-tax-privileged assets, regardless of the amount they will generally be subject to full taxation. However, an amount of up to 10 % of the net value, which results from the enterprise value reduced by the value of the non-operating assets, will be excluded. This value, which is likewise considered to be tax privileged, as a de minimis threshold (a so-called dirt premium), should serve to simplify matters. By contrast, if the value of the non-operating assets is more than 90 % of the fair value of the business assets then, overall, this shall be deemed to be not worthy of being protected.

With respect to the question of if and to what extent relief can be granted, in future, the basis for this will be solely the holding period and the aggregate wages that can be achieved. The latter increases as the number of employees rises, as can be seen in table 1 shown below.

Up to 5 employees		
Regular relief	Holding period: 5 years no aggregate wage test	Basic relief of 85 %
Optional relief	Holding period: 7 years no aggregate wage test	Basic relief of 100 %
Number of employees	**Regular relief**	**Optional relief**
6 – 10	Aggregate wages 250%	500 %
11 – 15	Aggregate wages 300%	565 %
16 or more	Aggregate wages 400%	700 %

Table 1 – Relief regulations

» **Please note:** You should bear in mind that, with immediate effect, relief may only be applied to the tax-privileged assets and not, as previously, to all

the assets. By contrast, non-operating assets, as non tax-privileged assets, allowing for the above-mentioned 10 % de minimis threshold, will generally be fully taxed.

III. Less relief for large acquisitions

According to the Federal Constitutional Court, when large business assets are transferred there needs to be a specific justification for the relief regulations to apply. With respect to the question of when assets should be classified as 'large', the legislature was guided by the inheritance tax rates. These specify the highest tax rate for acquisitions above € 26 m. Accordingly, the latest draft law draws the line there, too. If the assessed value for tax purposes of the business assets is more than € 26 m (per purchaser/donee) then an economic needs test has to be performed. For this, the beneficiary has to provide evidence that s/he requires tax relief and, for this purpose, disclose his/her private financial status to the local tax office. Half of the private assets have to be used to settle the tax liability.

If the purchaser does not wish to disclose his/her personal financial circumstances then taxes shall be assessed on the basis of the so-called Abschmelzmodell (ablation model). In this case, upon application, the basic relief is reduced from 85 % or 100 % respectively by 1% for each entire € 750,000 tranche by which the value of the tax-privileged assets exceeds the amount of € 26 m. Therefore, for tax-privileged assets starting from € 89.75 m (regular relief) or at € 90 m (optional relief) the basic relief will be 0 % (in the governmental draft from 8.7.2015, relief at a fixed flat rate was still envisaged as well as the reduction in the percentage points of the basic relief in steps of € 1.5 m).

» **Please note:** You should bear in mind that – in accordance with the previous regulations – several acquisitions of tax-privileged assets from the same person within 10 years will be added together). If the most recent acquisition leads to this limit being exceeded then the relief will basically not apply to all the acquisitions taken together. However, as a way out, a waiver or the ablation model still remain. While acquisitions under the 'previous' law are included in the calculation of the limit of € 26 m, nevertheless, they remain unaffected, i.e. back tax will not arise in this respect.

In some cases the protective shield is bigger due to the new relief provisions

IV. Valuation and tax privileges

The value of the assets to be transferred can be determined on the basis of the so-called simplified income capitalisation method. Up to now, the capitalisation factor was determined on the basis of, among other things, the current basic rate of interest. As the basic rate of interest is low, the capitalisation factor for 2016 was 17.85. In future, regardless of the current interest rate development, this will be 13.75 until further notice. Through this adjustment there should be a more realistic presentation of enterprise value in view of the current low level of interest rates. This amendment was a response to the justified

SIMPLIFIED INCOME CAPITALISATION METHOD
Comparison of the old and new laws

	OLD LAW	NEW LAW
Annual income (average for the past three years; subsections 201 and 202 of the German Valuation Act)	1 m	1 m
Premium on the basic rate of interest (subsection 203(1) of the German Valuation Act, as amended)	4,5 %	
Basic rate of interest 1.1.2016 (subsection 203(2) of the German Valuation Act, as amended)	1,10 %	
Discount rate = Total	5,60 %	
Capitalisation factor (inverse value subsection 203(3) of the German Valuation Act, as amended; specified in accordance with subsection 203(1) of the German Valuation Act, as amended)	17,85	13,75
The capitalised earnings value is the product of annual income and the capitalisation factorr	17,85 m.	13,75 m
Lower capitalised earnings value according to the new law in %		22,97 %
Regular relief 85 %	15,17 m.	11,69 m.
Taxable acquisition	**2,68 m.**	**2,06 m.**

Table 2 – Comparative calculation for the simplified income capitalisation method

criticism of the constitutionality of the overvalutions up to now. The respective comparative calculation is presented in Table 2, below.

As family enterprises are especially important for the German economy there is the option of reducing the value of the tax-privileged assets by up to 30 %. Therefore, the share of a family enterprise can be worth up to € 37 m without an economic needs test, within the meaning of the abatement model, being necessary. The pre-conditions for this are that

- in the company agreement withdrawals or profit distributions shall be limited to 37.5% of the share of the profits
- positions may only be made in favour of relatives within the meaning of section 15 the (German) Fiscal Code and,
- in the event of leaving the company, a financial settlement below the fair market value is provided for.

» Please note: These pre-conditions need to be fulfilled continuously two years before and twenty years after the succession case or gifting.

NON-OPERATING ASSETS
Comparison of the old and new laws

	OLD LAW	NEW LAW
The capitalised earnings value is a product of the annual income and the capitalisation factor	€ 17,85 m	€ 13,75 m
Share of non-operating assets € 5 m (assumption)	€ 5,00 m	€ 5,00 m
Therefore eligible for relief	€ 17,85 m	€ 8,75 €
Basic relief 85 %	€ 15,17 m	€ 7,44 m
Remaining as taxable business assets	€ 2,68 m	€ 1,31 m
Add non-tax-privileged non-operating assets	€ 0 m	€ 5,00 m
Taxable acquisition	**€ 2,68 m**	**€ 6,31 m**

Table 3 – Non-operating assets under old and new laws

V. An overview of the key effects

As non-operating assets are non tax-privileged assets and have to be fully taxed, in future, for many legal heirs or donees a higher tax burden will arise as can be seen in the sample calculation in Table 3, where the assumed share of non tax-privileged assets is worth € 5 m.

So that the inheritance tax charge does not threaten the survival of a company, the legislature has created the option – only in succession cases, not for gifting – of deferring payment of inheritance tax for seven years. However, only the first year would be interest-free and, for the additional six years, the tax liability would accrue interest at a rate of 6 %. A deferral can ensue upon application so long as there is compliance with the rules pertaining to aggregate wages and holding periods.

By contrast, those who previously were not able to benefit from tax relief on account of holding more than 50 % of non-operating assets will be able to profit from the new rules.

» Recommendation: If family enterprises fulfil the described criteria then there is a possibility of a maximum reduction in value of 30 %. In order for it to be possible to make use of this tax privilege it is advisable to check your own company agreement in good time and, if required, adapt it to the new legal situation.

VI. Outlook

The draft law was approved by the Bundestag and the Bundesrat, nevertheless, it remains to be seen whether or not the law is able to withstand a legal review by the Federal Constitutional Court.

Once the Federal President signs the law it will come into force and apply retroactively to 1.7.2016. By contrast, capping the capitalisation factor, usually for the benefit of the taxpayer, at 13.75 times should be applicable already to transfers as of 1.1.2016.

TAX

International legislative changes

The German government introduced the draft of an 'act to implement the amendments to the EU mutual assistance directive and other measures against earnings erosion and profit shifting' into the legislative process in September. This act seeks to take into account in particular changes in international tax law. The context of the act is the implementation of measures that were proposed by the OECD as a response to fiscally undesirable tax minimisation strategies ('Base Erosion and Profit Shifting' – BEPS). We have summarised below selected aspects while taking into consideration the opinion statement of the Bundesrat (upper house of German parliament) that has been published in the meantime.

1. Country-by-country reports

The governmental draft includes an obligation for large international companies to prepare a so-called country-by-country report (CbCR) and submit it to the tax authorities (cf. also PKF Newsletter issue 07-08/2016). Subsequently, the data contained therein should be exchanged between the tax authorities of the states concerned.

German parent entities will have to prepare a CbCR for the first time for financial years that started after the 31.12.2015. The report will have to be submitted to the German Federal Central Tax Office (Bundeszentralamt für Steuern, BZSt) within one calendar year after the end of the relevant financial year.

II. International exchange of information

Through an amendment to the EU Administrative Assistance Act, information about cross-border preliminary notifications and advance agreements with respect to transfer price issues, from tax authorities, (so-called tax rulings) will be automatically exchanged among the EU member states. The exchange of information, in some cases, also concerns tax rulings that are no longer valid. The government hopes that these measures will lead to a reduction in tax competition through increased transparency.

» **Please note:** The exchange of information should be applicable to small and older cases, with certain exceptions, as of 1.1.2017.

III. Restrictions on tax deductibility of special business expenses that contain a foreign element

According to the proposal of the Bundesrat, the expenses incurred by a foreign partner should not be deducted as special business expenses in Germany if these expenses also reduce the tax assessment basis in another state. This is intended to prevent the fiscally undesirable double deduction arrangements that could arise if

- Germany takes into account, for tax reduction purposes, the special business expenses that can be allocated to a German permanent establishment while, at the same time,
- in the partner`s foreign home state, the income from the German permanent establishment may qualify for a tax exemption but, nevertheless, offsetting the expenses against taxes is permissible.

An exception may be made if the expenses are connected with the partners income that is demonstrably subject to tax in another state.

» **Please note:** It should be presumed that the first time application will be in 2016 already.

IV. Trade tax in the taxation of CFC income

Within the scope of the taxation of (Controlled Foreign Corporation) CFC income, so-called passive income (e.g. from interest, trading or services without participating in general commerce) is added back to domestic earnings. The add-back rules apply if individuals who are resident in Germany for tax purposes control a foreign corporation and the tax liability on the respective income is below 25 %. This so-called taxation of CFC income happens without preferential tax treatment such as withholding tax or the partial income rule.

According to a Federal Fiscal Court (Bundesfinanzhof, BFH) ruling, the amounts that are added back are not subject to trade tax (c.f. PKF Newsletter 12/2015). The German government wants to scrap this ruling and, as of 2017, to apply trade tax to the amounts that are added back.

V. Expansion of restricted tax liability when selling shareholdings in corporations

In future, those who are non-resident in Germany for tax purposes should be subject to German tax on their gains from the disposal of shareholdings in corporations if already more that 50 % of the value of the corporate assets is directly or indirectly derived from immovable assets in Germany. Thus, the German tax authorities are claiming the right to tax gains from the disposal of shareholdings in corporations that have invested in domestic real estate, regardless of the size of the ownership interest of the shareholder and also irrespective of where the headquarters and/or place of management of the corporation are located.

» **Please note:** The first time application is planned already for the 2016 assessment period.

VI. Amendments to Section 50i of the German Income Tax Act

The tax on the disjunction of assets in DTA cases of departure targets arrangements where assets are transferred in advance to a partnership that is deemed to be of a commercial nature. As the commercial nature is not rec-

ognised abroad, Germany no longer has the right to tax. Section 50i(1) of the German Income Tax Act (Einkommenssteuergesetz, EStG) provides that certain gains from the disposal or withdrawal of assets from partnerships shall be subject to tax in Germany even if Germany‘s right to tax has been restricted or excluded through a DTA. Moreover, in the case of reorganisations and contributions of groups of assets, which include such economic assets, a transfer at the carrying amount is not possible, but instead, the realisation of all the hidden reserves is prescribed (Section 50i(2) of the EStG).

These provisions have been strongly criticised by business and, moreover, the Federal Ministry of Finance will grant an exemption, upon request, from the statutory provisions. The changes to the law should ease these statutory rules.

- In cases where Germany`s right to tax has been restricted or excluded, Section 50i(1) of the EStG should now only be applicable up to 31.12.2016. However, this ultimately means that there will routinely be no relief as the general rules, e.g. tax on the disjunction of assets, shall apply to subsequent cases.
- Moreover, it is proposed that Section 50i(2) of the EStG should no longer stipulate that the fair market value approach has to be used for transferred groups of assets in the case of contributions within the meaning of Section 20(1) of the German Reorganisation Tax Act. Instead, only the value of the assets that are at risk from being restricted or excluded from Germany`s right to tax within the meaning of Section 50i(1) of the EStG. These new rules should be applied to all contributions for which the contribution agreement was concluded after 31.12.2013.

Acquisition related production costs in the case of building works – Federal Fiscal Court has rejected the exclusion of decorative repairs

» **Who for:** Taxpayers who carry out building works three year after acquiring a building.

» **Issue:** The Federal Fiscal Court (Bundesfinanzhof, BFH), in three rulings from 14.6.2016, has fleshed out the term “maintenance and modernisation measures” in Section 6(1) no. 1a of the German Income Tax Act (Einkommenssteuergesetz, “EStG”) for those cases where, shortly after the acquisition, besides other renovation measures, purely decorative repairs are carried out.

In the cases in question, the claimants had each purchased buildings and, shorty after acquiring them, had remodelled, refurbished and overhauled them and, subsequently, had rented them out. In the course of this, work was carried out on the heating, windows, sanitary and electrical installations and decorative repairs were also made. As the overall net costs of the refurbishments exceeded the acquisition costs for the building by 15 % in each case, the local tax office, in accordance with Section 6(1) no. 1a of the EStG, assumed that these were “acquisition related” production costs that have to be offset against tax through depreciation. The taxpayers, however, were of the opinion that the costs for purely decorative repairs (e.g. wallpapering and painting) should at least be viewed seperately.

Yes to decorating - no to stripping out

In its recent rulings, the BFH disagreed with this opinion. Accordingly, even purely decorative repairs as well as measures that make a building ready for use in the first place (make it lettable), or that result in a significant improvement on its original condition are included under the term “maintenance and modernisation measures” within the meaning of Section 6(1) no. 1a, clause 1 of the EStG.

Following this ruling, from now on, all the costs incurred for the building measures that form part of a refurbishment carried out in connection with the acquisition of a building will be added together. A segmentation of the overall costs is not permitted.

» **More information:** The BFH rulings from 14.6.2016 (case references: IX R 25/14, IX R 15/15, IX R 22/15) are available at www.bundesfinanzhof.de (German version only).

Retroactively correcting invoices is permissible according to the ECJ

Who for: All companies, in particular, business owners who have to pay interest on tax arrears due to incomplete invoices (Section 233a of the (German) Fiscal Code).

Issue: In order for business owners to be able to deduct the input tax from incoming invoices, under Section 15(1) clause 1 no. 1 of the German VAT law, it is assumed that they have invoices that include the information listed under Section 14(4) of the German VAT law. Input tax deduction from an incomplete invoice is not permitted.

The ECJ recently ruled on a case where, in the course of an external audit, the local tax office had found that the invoices from which the claimant had deducted input tax did not meet formal requirements. The tax numbers or the VAT identification numbers of the supplying businesses were missing. The invoices were corrected while the external audit was still being carried out. In the opinion of the tax authorities, an incomplete invoice can be corrected and, in this way, the input tax deduction will be enabled. However, the correction of the invoice does not have a retroactive effect, i.e. back to the assessment period in which the invoice was issued. Accordingly, for each year that had elapsed since the unauthorised deduction of input tax, the tax authority requested that interest on tax arrears be paid at a rate of 6 %.

By contrast, in its ruling from 15.9.2016, the ECJ decided that invoices could be corrected retroactively. The basic principle of VAT neutrality requires that input tax deduction should be allowed even if certain formal preconditions have not been met.

Further clarification is needed as to the extent to which this ruling, which related specifically to the correction of tax numbers or the VAT identification numbers, is transferable to other prescribed invoice components. This is questionable, e.g., in view of the requirement to include the recipient of the goods or services and the supplying business as well as the VAT charge. Furthermore, the ECJ pointed out that Member States may impose sanctions in cases where the formal requirements have not been met. However, delaying the exercise of the right to deduct input tax, which is linked to the practice of charging interest on tax arrears, is disproportionate.

Fewer confidential issues due to extraordinary rights to information

Recommendation: Companies that have paid interest on tax arrears in the past should check to see whether or not it is possible to obtain a refund. In order to avoid interest on tax arrears, any cases that are currently still pending can be kept open through objections that make reference to the recent ECJ ruling. Regardless of this, any necessary corrections to invoices should always be carried out promptly. Indeed, it is not possible to correct an invoice if the supplier of the goods or services subsequently no longer exists or is no longer available. Moreover, the ECJ did not state whether or not a correction to an invoice potentially has a retroactive effect only up to a certain point in time.

More information: The ECJ ruling from 15.9.2016 (case: C-518/14 – Senatex) is available at www.curia.europa.eu.

LEGAL

The extraordinary right to information of a limited partner

Who for: Shareholders of limited partnerships.

Issue: In a recent ruling, the Federal Court of Justice (Bundesgerichtshof, BGH) fleshed out the extraordinary right to information of a limited partner. According to Section 166(1) of the HGB (German Commercial Code), a limited partner has a general right of information as regards the annual financial statement and keeping of financial accounts. Up to now, it has been unclear whether or not the extraordinary right to information, pursuant to Section 166(3) of the HGB, which requires compelling reasons, likewise relates only to information that is relevant for the audit of the

annual financial statement.

In the recently published opinion of the Federal Court of Justice (Bundesgerichtshof, BGH), the extraordinary right to information can also be aimed at information about management, the documents related to this and at the general partner. It should be assumed that there is a compelling reason if supervision of management is necessary in the interests of the limited partners, e.g., in the case of a threat of harm to the company or the general partner. A limited partner has to set out such circumstances in concrete terms.

However, the BGH pointed out that an extraordinary right to information does not extend to briefing the limited partners at all times. Section 166(3) of the HGB justifies only such rights to information and explanation that are appropriate and proportionate for the enforcement of rights under a partnership agreement, or of the legitimate interests of the limited partners. There should not be any connection between influencing day-to-day management and the extraordinary right to information.

» **Recommendation:** Now that the extent of the extraordinary right to information has been clarified, insofar as there are compelling reasons, there is a wide ranging right to information available to public companies, or if there is a dispute between shareholders. This right should be a part of the tactical approach that is adopted.

» **More information:** The recent BGH ruling was from 14.6.2016 (case reference: II ZB 10/15) and is available at www.bundesgerichtshof.de. (German version only).

Employment law – Caution is required with respect to preclusive periods and minimum remuneration

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

» **Issue:** When standard preclusive periods, or ones in employment contracts (expiration clauses) are effectively agreed then claims arising from the employment relationship have to be asserted within short time limits in order to prevent the claims from being forfeited.

In this regard, the Federal Labour Court (Bundesarbeitsgericht, BAG) recently dealt with a case where a nursing assistant had been employed for almost six months at an outpatient care service by an employer against whom she had filed a complaint. During her period of employment she was certified as being incapacitated for work, but the employer did not continue to pay her remuneration. The employment contract contained an expiration clause within which the claims arising out of the employment relationship were to be asserted. The clause did not exclude claims in respect of statutory or other minimum wages (please note that entitlements to the statutory minimum wage are subject to the usual limitation period of three years). The employment relationship fell under the regulation on mandatory working conditions in the care sector that provides for minimum remuneration.

After the claimant had asserted her claim for continued remuneration in court, the employer invoked the expiration clause. In his opinion, the entitlement had lapsed because it had not been asserted in time.

The BAG ruled in favour of the claimant because it believed that the expiration clause was invalid. Therefore, the claimant had been entitled to continued remuneration during sick leave. She did not have to assert her claim within the expiration period under the employment contract, as the clause provided by the employer, against whom the complaint was filed, was a violation of the prohibition on the waiver of the minimum wage and, therefore, completely unenforceable.

» **Please note:** The BAG ruling could be understood as an indication with respect to a hitherto unclarified issue in connection with the statutory minimum wage. Currently, it is still disputed whether preclusive or expiration clauses in employment contracts that do not explicitly exclude entitlements to the statutory minimum wage are completely unenforceable, or whether these clauses can be upheld for entitlements other than the minimum wage. Should the BAG ruling be transferable to the statutory minimum wage and other minimum remuneration entitlements then this could result in the unenforceability of many expiration clauses under employment contracts. Since the legal situation here has not yet been clarified and in view of the recent BAG ruling, we would recommend that employers, in particular, should exercise the utmost care when formulating employment contracts with expiration clauses.

» **More Information:** The BGH press release with respect to the ruling from 24.8.2016 (case reference: 5 AZR 703/15) is available online at www.bundesarbeitsgericht.de (German version only).

ACCOUNTING

IT outsourcing including cloud computing – Risks in respect of compliance with the principles of proper financial accounting

The Institute of Public Auditors in Germany (Institut der Wirtschaftsprüfer, IDW) published an opinion statement – IDW RS FAIT 5 – from its expert committee on information technology (FAIT), on 4.11.2015, on the implications for accounting practices of outsourcing accounting-related processes and functions, including cloud computing. In this, the risks in respect of compliance with the principles of proper financial accounting when using cloud computing are specifically explained. In the following section we present the main features of IDW RS FAIT 5.

I. Background

Companies frequently outsource operational processes and functions such as, e.g., payroll accounting or computer centres to service companies. However, the responsibility for compliance with the requirements with respect to security and accuracy when keeping accounting ledgers by means of IT-based systems through a contracted service provider remains with the legal representatives of the outsourcing company.

Worldwide cloud computing overcomes national borders

II. Overview of IT outsourcing

Outsourced processes and functions are relevant for accounting if they serve the purpose of storing or processing data about accounting transactions and events, or operational activities. As a consequence, processes and functions that serve the purpose of storing and/or processing accounting-related data become part of a company`s IT system and its IT-based accounting system.

Typical examples of IT outsourcing mentioned in IDW RS FAIT 5 include:

- **Computer centre operation** – Processing of data in the business processes that are incorporated into the IT-based accounting systems.
- **Business process outsourcing** – Business processes such as, e.g., payroll accounting, bookkeeping, etc. are outsourced to service companies.
- **Shared service centre** – Functions such as accounting, personnel management, among others, are made centrally available to other group companies with the aim of reducing costs and enhancing efficiency.
- **For the provision of data via interfaces,** frequently, cloud computing is also used as a transmission channel. In the course of this, the data are uploaded into a virtual data room and the service provider can retrieve the data from there for further processing.

III. Risks when outsourcing IT

The risks associated with IT outsourcing that are mentioned include, in particular, errors in the areas of organisation and the division of responsibilities, interfaces and the transmission channels that are used, data storage and the storage location as well as change management. The use of public networks, such as the internet, or the consequences of security gaps at the contracted service company mean that there is an increase in the risk of unauthorised access to accounting-related data. Therefore, it is absolutely essential to have clear and transparent rules for internal and external access rights.

In addition, it is pointed out that if there is no allocation of responsibilities then there is a risk of failing to meet the security requirements that are a precondition for proper

accounting processes. IT interfaces also constitute an increased risk and, therefore, should undergo functional testing on a regular basis.

In view of the particular feature of cloud computing that the processing and storage of accounting-related data can be carried out via several computer centres in different countries, there is a greater risk of illegal access to the data. This can at least be restricted through the use of so-called 'private clouds'.

Furthermore, there are still numerous legal risks such as, e.g., with respect to the protection of personal data, copyright compliance, conflicting legal requirements of the individual countries with regard to the use of encryption technologies, etc.

IV. Risk governance through setting up an internal control system

In the event of an outsourcing of business processes and functions, the legal representatives of the outsourcing company have to ensure that there are effective controls to counter the above-mentioned risks.

Awareness of the potential risks is a crucial factor when setting up an internal control system. In the case of cloud computing, attention also needs to be paid to the fact that, for reasons of technology, it is much easier to switch the subcontractors of the service company. In this respect, monitoring switches of subcontractors of the service company is of particular importance.

In the area of IT infrastructure, first of all, the outsourcing company has to get an overview of the safeguards and security measures as well as the IT processes during regular and emergency operations at the service company. The emergency measures should be tested with respect to their functional capabilities. Insofar as the administration of the IT infrastructure is the responsibility of the service company, the outsourcing company has to obtain assurance that the controls that have been set up there are adequate. This should happen on the basis of appropriate reports from internal or external auditors.

If IT applications are outsourced then the requirements under the principles of proper financial accounting have to be fulfilled to the same extent as for in-house operations. That is why proper processes have to be ensured through application-related monitoring activities and general controls. The outsourcing company can get an overview by inspecting the process documentation or by means of software certification.

In order to be able to guarantee compliance with the requirements pertaining to security, accuracy and controls for the outsourced IT-based business processes, rules have to be established, together with the service company, in the form of an operating procedures manual, or service level agreements.

» **Recommendation:** The outsourcing of operational functions does not release the management from the obligation to ensure that these functions are performed properly. This should be assured by establishing appropriate arrangements for data security and clear rules governing responsibilities and flanked by suitable monitoring measures.

CORPORATE FINANCE

Analysis of country risks for the financial projection

In their operating businesses, for the most part, companies depend on sales in foreign markets, or on procurement from abroad. Therefore, country risks should be taken into account in the financial projection for the operating business, corporate transactions as well as for the valuation of existing shareholdings by using appropriate methods.

I. Examples of country risks

Country risks (cf. overview Fig. 1) can affect future developments in various ways and cannot be considered independently. Revenues and the cost of materials are largely determined by economic developments in the countries of the customers or the suppliers. Moreover, currency risks are also relevant if the currencies for invoicing and for procurement are different. Furthermore, political risks can affect the operating business, e.g., through administrative requirements, rules, or prohibitions.

Planned capital spending, particularly in politically unstable countries, could entail the risk of expropriation and also security risks (e.g. the destruction of plants and machinery). There is a fiscal risk for tax expendi-

ture that lies, among other things, in the possibility of the short term elimination of tax privileges, or in the complexity of a foreign tax system. Ultimately, the foreign profits that are generated are also subject to a transfer risk, in addition to the currency risk, as capital and currency controls could restrict the repatriation of invested capital and profits.

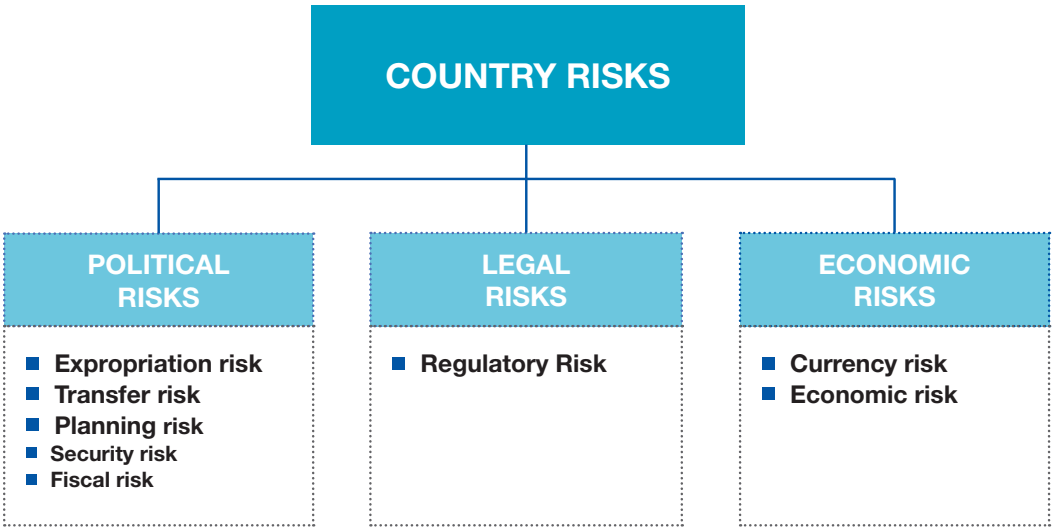

Fig. 1 Classification of country risks

II. Taking country risks into account in the financial projection

In the planning process, country risks can be taken into account in three stages.

(1) Impact of economic country risks on the business model and the operating business – The starting point is a consideration of the possible effects of economic developments and the currency risk on a company`s specific operating business. There are numerous sources available for the forecast of economic developments (e.g. macroeconomic data from the International Monetary Fund, or analyses from industry associations) that can help to prepare an adequate assessment of your own market position and of growth in the respective country. For a currency forecast, in practice, market-based forecasts in the form of forward rates are frequently used. Brokers and banks calculate and can provide forward rates.

(2) Effect of other country risks – You should examine the extent to which other country risks, besides the economic risks, could affect the future financial position, cash flows and results of operations. In the course of this, quantifying political and legal risks usually turns out to be difficult. One option is to consider hypothetical insurance premiums in the case that it is possible to obtain risk insurance.

(3) Sensitivity analyses and scenario calculations – In practice, frequently, only a single one-dimensional plan is prepared on the basis of the most probable scenario. However, such a plan does not sufficiently depict all the inherent business risks. For this, a plan is required that reflects plan variances in the form of opportunities and risks with their occurrence probabilities. Based on the analysis of the effects of the risks on the business value drivers you should prepare base, downside and upside scenarios for the respective variations in these value drivers.

» **Recommendation:** Forecasting country risks and taking them into account is complex and should be company-specific. In order to make the country risks in your own business more transparent and, in this way, effectively manage the foreign activities it can be helpful to prepare sensitivity analyses and scenario calculations.

IN BRIEF

Input tax deduction for invoices with two dates

In the course of VAT audits, currently, the preconditions for input tax deduction are being particularly scrutinised. If an invoice contains two dates, where the first date corresponds to the date of supply and the second date to the date of despatch the input tax may only be deducted at the later date.

In order to be able to deduct input tax a business owner has to have a proper invoice and this relevant date should be documented with a stamp that shows the date of receipt.

Impact on EU state aid control

The EU Commission is responsible for monitoring state aid. This gives it the right to regulate competition also in the policy areas where it has no subject matter jurisdiction (e.g. fiscal policy, employment policy). That is why any planned state aid-related measures have to be reported to ('notification' is required) and approved by the EU Commission. Competitors are able to call the EU Commission via their Member State and ask it to exercise oversight over state aid for a rival.

Until exit negotiations are concluded, the UK has to abide by EU law and may not unilaterally suspend it. Moreover, as EU law has priority, the UK may not issue any regulations that deviate from EU law either. So, for example, it is not possible to make corporate tax cuts that are not consistent with EU state aid law. Currently, the inadmissibility of deviations from EU state aid rules is perceived to be problematic in the area of the British steel industry.

Once the UK leaves the EU, the Commission will no longer have any influence on aid that is illegally granted by the UK. By the same token, the UK will not be able to take action against aid in other EU Member States (apart from the basic protection under GATT provisions).

After the UK's exit from the EU has been completed, the effects on companies and their subsidiaries will ultimately depend on whether the EU provisions that are currently applicable will be replaced by a domestic state aid monitoring system, or whether the UK completely refrains from having its own regulations.

AND FINALLY …

"If a problem has no solution, it may not be a problem, but a fact – not to be solved, but to be coped with over time."

Shimon Peres, 2.8.1923 – 28.9.2016, Israeli politician and Nobel Peace Prize Laureate. He was the President of Israel from 2007 up to 24.7.2014.

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