PKF

Accountants &
business advisers

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Editorial

Dear Readers,

Recent legislative amendments have placed restrictions on the international mobility of the shareholders of family enterprises and the changes now harbour significant tax risks. In our series on international tax law, in the “Focus” section, we examine the tax-structuring pillar on the basis of a case study and we present a possible solution.

In the “Tax” section, first of all, we discuss an ECJ ruling on value-added tax that is favourable for **holding companies** that practise active shareholder management. Moreover, in future, the ruling could also enable commercial partnerships to be a subsidiary company in a tax group. In another report, we look at a decision by the Federal Constitutional Court, which finds that the assessment basis for **Real Estate Transfer Tax** for plots of land that have been transferred without a purchase contract is too low and, therefore, unconstitutional.

In the “Legal” section, we discuss the **minimum wage** and the welcome simplifications with respect to record keeping as well as the need for companies who engage subcontractors to exercise caution. Greater certainty will come about as a result of the new **EU inheritance law**, which enables succession cases to be allocated accordingly.

The opinion of the tax authorities on the realisation of profits from **progress payments**, which you can read about in the “Accounting” section, in conjunction with the new IFRS 15 will probably have an effect that will permeate through to German commercial law, too. By contrast, based on a legal interpretation by the Federal Ministry of Finance, the scope of application of the LIFO method for the **valuation of inventories** will remain narrow.

In our “Corporate Finance” series, we take a closer look, from the perspective of medium-sized enterprises, at different **internationalisation strategies** and implied risks.

We hope that you find this newsletter stimulating reading.

Yours sincerely,
Your PKF Team

Contents

FOCUS

Avoiding double taxation when shareholders internationalise

Whether it be a course of study abroad in Oxford, a gap year volunteering in Africa, or being an expat in the USA, the possibilities for gaining experience abroad are almost unlimited. Moreover, experience abroad is also important for shareholders of German family enterprises, not least in the interest of their own companies. However, in the course of this, the risk of double taxation should not be overlooked.

I. Previous legal situation

Frequently, the starting position at German family enterprises is as follows (Fig. 1).

In this connection, the tax authorities held the view that Germany had the right of taxation even after shareholders had moved to a foreign country. Given the commercial nature of partnerships, shareholders continue to generate taxable income from their indirect stake in the Group holding company. Moreover, proceeds from a sale were also liable to tax in Germany.

Fig. 1

II. New legal situation

In a number of rulings from 2010 and 2011, the Federal Fiscal Court (*Bundesfinanzhof*, BFH) disagreed with this opinion. It was argued that, based on the criteria of double taxation agreements (DTA), the commercial nature of a partnership was not sufficient to confer the right to tax on Germany. The background to this was that, in many other states, the commercial nature of a partnership cannot be brought about by having a GmbH (German limited company) as a general partner. Outside of Germany, such companies are considered to be transparent for tax purposes.

In 2013, in order to protect the taxation of hidden reserves that exist, or are generated in Germany, Section 50i was newly introduced into the German Income Tax Act. According to this, in these and in similar cases, Germany retains the right to tax notwithstanding any other provisions to the contrary in a DTA. The provision applies to ongoing income as well as to gains from the divestment of shareholdings.

The four pillars of international tax law at PKF – the topic of our Focus section in the newsletters for the period 06/2015 – 10/2015.

The upshot is that, without counteractive arrangements, it is no longer possible for the shareholders concerned to move abroad for professional reasons for longer (or indefinite) periods without the foreign state (in accordance with the DTA) and Germany (because of Section 50i of the German Income Tax Act) each claiming the right to tax. This results in real double taxation.

III. Avoiding double taxation

Family enterprises, or their shareholders are therefore faced with the task of structuring their companies in such a way that will still allow the shareholders to be able to operate internationally. One model is to implement a managing holding company in the legal form of a partnership, usually as a so-called GmbH & Co. KG (a German limited partnership with a limited liability company as a general partner) (Fig. 2).

Abb. 2

In this type of restructuring, the shares of a partnership, which is deemed to be of a commercial nature, in the current group holding company (GmbH/AG) are contributed to a new group holding company (GmbH & Co. KG), in a tax neutral way, and in return the latter grants new shares. This structure results in

- the creation of an operational group head office, which is a permanent establishment as defined in both DTAs as well as in the BFH ruling;
- the right to tax, in the event of shareholders moving abroad, being retained by Germany pursuant both to DTAs as well as national law;
- the international mobility of shareholders remaining unaffected, which means that they are able to gain foreign experience without any constraints arising from the family enterprise or tax considerations;
- the identification with and business connection to Germany being maintained.

However, there are risks associated with such a restructuring as, contrary to the German Reorganisation Tax Act, in 2014 the German government introduced Section 50i(2) of the German Income Tax Act to no longer permit tax neutral reorganisations or contributions in these cases.

Resolving the conflict between "protecting Germany's right to tax vs. the (necessary) international mobility of shareholders" should be in the best interests of the German government and the tax authorities. However, in order to be able to carry out a restructuring within a group with legal certainty there is a need for clarification, or restrictions on 50i(2) of the German Income Tax Act with respect to cases of misuse. An appropriate decree from the tax authorities is eagerly awaited and is absolutely imperative.

» **Recommendation:** When restructuring to avoid double taxation you can rely on support from PKF experts who can tailor solutions to meet the specific needs of your company structure and who will keep a close eye on the legal interpretations of the tax authorities.

TAX

ECJ – A management holding company is permitted to deduct input tax – The conditions set by Germany for tax groups contravene EU guidelines

» **Who for:** Holding companies that practise active shareholder management (so-called management holdings) as well as groups with partnerships.

» **Issue:** In its rulings from 16.7.2015, the ECJ decided on two pivotal issues relating to value-added tax in groups.

(1) Input tax deduction – The first issue concerned the attribution of the input tax deduction for costs incurred in connection with the acquisition of shareholdings in subsidiary companies ("capital transaction costs"). Here, up to now, only a pro-rata deduction of input tax had been possible based on the proportion of services that are subject to VAT and those that are exempt from VAT. In the case of a so-called management holding, the ECJ now permits full input tax deduction for the capital transaction costs. By contrast, in the case of passive management of shareholdings, the input tax included in the financial transaction costs is not deductible, or if the management of shareholdings is partially active and partially passive then the input tax has to be divided up accordingly. However, the ECJ did not specify criteria for dividing up the input tax, as this should be determined on the basis of national rules.

(2) Partnerships as subsidiary companies – The second issue related to the German regulation that stipulates that a

partnership cannot be a subsidiary company in a tax group (for VAT purposes). In the opinion of the ECJ, the 'blanket' restriction to legal entities (in particular, corporations) is not permissible. Making such exclusions is only possible to the extent that national rules serve to prevent abuse or tax evasion. It is now incumbent on the Federal Fiscal Court to check this. The German government might soon have to come up with new rules on tax groups for VAT purposes.

» **Recommendation:** Once again, the management holding company turns out to be advantageous. In this respect, we would like to refer you to our report in the 'Corporate Finance' section of the 07-08/2015 issue of the PKF newsletter. The broader possibility of input tax deduction should be reviewed, in particular, for the current business year. It remains to be seen what the response of the German government will be with respect to tax groups for VAT purposes. New possibilities for optimising VAT in groups of companies could emerge. Your PKF experts will keep you informed in this respect.

» **More Information:** You can look up the ECJ ruling from 16.7.2015 online under the case references: C-108/14 and C-09/14 at www.curia.europa.eu.

Real Estate Transfer Tax – The Federal Constitutional Court declares the surrogate assessment basis to be unconstitutional

» **Who for:** Real estate buyers who, in recent years, have paid Real Estate Transfer Tax (RETT) on the basis of a surrogate assessment.

» **Issue:** RETT is usually calculated on the basis of the value of the consideration (e.g. the purchase price). By way of derogation, a so-called surrogate assessment basis (*Ersatzbemessungsgrundlage*, or "Ersatz-BMG" for short) is applicable

- if there is no consideration, or if it cannot be determined,
- in the case of reorganisations, contributions and similar events,
- if, in the case of a commercial partnership, a shareholding of 95 % or more is exchanged within five years.

In this respect, the Federal Constitutional Court, in its ruling from 23.6.2015, decided that the current practice of determining the "Ersatz-BMG" is unconstitutional. It found that values determined in accordance with this method were, on average, 50 % below the usual purchase price for real estate that had been developed, around 30 % in the case of undeveloped real estate and even up to 90 % in the case of agricultural and forestry land. The Federal Constitutional Court believes that these serious divergences result in unequal treatment of those taxpayers for whom RETT was determined on the basis of the actual purchase price. This constitutes a violation of the principle of equality, which is enshrined in the Basic Law. The German government is accordingly obliged to agree new rules by 30.6.2016, at the latest.

The tax charge will probably go up for events where, up to now, the RETT has been determined on the basis of the "Ersatz-BMG". As the rules will have to be applied retroactively to 1.1.2009, notices of assessment of RETT, which in the past were issued with a comment to the effect that the statement was preliminary, will have to be amended.

» **Recommendation:** As RETT is usually included in the ancillary costs of acquisition, the increase in the RETT charge will be (partially) offset by depreciation.

» **More Information:** The Federal Constitutional Court ruling can be found under case reference 1 BvL 14/11 at www.bundesverfassungsgericht.de. (German version only).

LEGAL

Minimum Wage Act – Federal Ministry of Labour and Social Affairs has provided simplifications and clarifications

» **Who for:** Employers and employees, particularly those who fall under the minimum wage regulations.

» **Issue:** Since 1.1.2015 there has been a generally applicable statutory minimum wage of € 8.50 in Germany, however, many issues have still not been clarified.

(1) Record keeping obligations – In the decree on Minimum Wage Documentation Obligations (*Mindestlohndokumentationspflichtenverordnung*, MiLoDokV) the Federal Ministry of Labour and Social Affairs (*Bundesministerium für Arbeit und Soziales*, BMAS) has now decided that, with effect from 1.8.2015, the obligation for the sectors mentioned in the legislation to keep a record of working hours may be omitted if the regular remuneration is more than € 2,000 gross/month and if it has been verifiably paid over the last 12 months. The previous threshold of € 2,958

gross/month will still be applicable if no proof of payment is provided. Furthermore, close family members (spouses, registered partners, children and parents of the employer) who are employees and the authorised bodies of legal entities as well as partnerships with legal capacity will be exempted from the record keeping obligations.

(2) General liability of contractors – Moreover, according to a recent announcement from the BMAS, the so-called general liability of contractors will be restricted in a practice-oriented way. Liability for the payment of the minimum wage to employees who are deployed at a subcontractor shall be restricted to those cases where a business has passed on these contractual obligations to other companies. Thus, for example, a building contractor will be liable for the minimum wage of a subcontractor's employees. The BMAS is endeavouring to clarify that liability shall apply to neither private individuals nor businesses that make use of a service for their own companies.

» **Recommendation:** In view of the unresolved legal issues, further developments should be carefully monitored. You can learn more about this topic at www.der-mindestlohn-wirkt.de (German version only).

Amendments to inheritance laws for succession cases that involve other EU states

» **Who for:** People who are habitually resident in other EU states.

» **Issue:** Since the 17.8.2015, the European Succession Directive has been applicable to cross-border succession cases for EU member states (with the exception of Great Britain, Ireland and Denmark). In the future, the European Succession Directive should help to avoid the difficulties that are associated with the settlement of cross-border successions. Nevertheless, national succession cases without a foreign element will continue to be subject to the inheritance laws of the respective states. In the following section we give an overview of the most important provisions in the European Succession Directive:

(1) Relevance of habitual residence – Under the hitherto applicable inheritance laws, the execution of cross-border succession was subject to the law of the state of which the testator was a national at the time of death. In future, under the European Succession Directive, the last habitual place of residence will be relevant. For Germans who, at the time of death, were habitually resident in, for example, Spain, for the settlement of their successions, in future, Spanish inheritance laws will apply. Habitual residence would be assumed if, on the basis of actual circumstances, it is possible to determine that the person concerned was not living only temporarily in the relevant place. A stay that is not deemed to be only temporary, in principle, covers a continuous period of more than six months and one which was intended as such right from the start(!).

(2) Choice of an applicable law – Those living in EU states for longer periods who wish to ensure that foreign inheritance laws will not be applied can expressly choose the applicable law. To this end, in their wills or succession agreements, testators have to clearly specify that the applicable inheritance laws shall be those of the states of which they are nationals.

(3) European Certificate of Succession – The European Succession Directive will also result in the introduction of the so-called "European Certificate of Succession", which as an official document will designate entitled heirs. Thus the certificate of inheritance that was hitherto frequently required as documentary evidence of the status of heirs will become obsolete.

» **Recommendation:** Inheritance rules in other EU states should not be considered per se as disadvantageous when compared with German inheritance laws. The persons concerned should seek advice as to which inheritance laws are more favourable for their estate. In order to avoid uncertainty, the appropriate choice of applicable law should then be recorded in the will or succession agreement.

» **More Information:** An information sheet and other details (in German) about the European Succession Directive can be found at www.bundesregierung.de.

ACCOUNTING

Realising profits in the case of progress payments – The Federal Ministry of Finance widens the scope of application

» **Who for:** (Work) contractors who prepare accounts and issue partial invoices.

» **Issue:** In a ruling from 14.5.2014, the Federal Fiscal Court (*Bundesfinanzhof*, BFH) decided that partial invoices

for individual performance phases, based on the Ordinance on Architects' and Engineers' Fees (*Honorarordnung der Architekten und Ingenieure*, HOAI), result in the realisation of profits immediately and, thus, may no longer be reported under work in progress. The tax authorities have adopted the new ruling and, in a Federal Ministry of Finance (*Bundesministerium der Finanzen*, BMF) circular, they clarified that it is applicable not only to claims arising from partial invoices based on the HOAI but also to those in accordance with Section 632a of the German Civil Code. For this reason, all (work) contractors who are able to request progress payments when the customer realises value appreciation are thus affected.

The impact of this new perspective will, indeed, not be insignificant, however, there will be no objection if this amended legal interpretation is used as a basis, for the first time, for annual financial statements as at 31.12.2015. Furthermore, with respect to the profit that results from the first time application, there will be an option to spread it evenly across two or three years, as of the year of the first time application.

» **Recommendation:** The Institute of Public Auditors in Germany (*Institut der Wirtschaftsprüfer*, IDW) considers this latest opinion of the BFH and BMF to be wrong. According to the principles of proper financial accounting, in contracts of work, profits are only realised at the time when risk is transferred, thus, usually at the time when the work is accepted. Those who invoke this principle and continue to report work in progress and advance payments received, should explicitly point out the different accounting treatment in their tax returns in order to pre-empt any allegations of tax offences.

» **More Information:** The above-mentioned BMF circular from 29.6.2015 is available for download at www.bundesfinanzministerium.de and the IDW opinion statement at www.idw. de/idw/portal (German versions only).

The Federal Ministry of Finance has provided an interpretation of the LIFO method for the valuation of inventories

» **Who for:** Taxpayers who prepare accounts and have to value their inventories.

» **Issue:** In a circular from 12.5.2015, the tax authorities clarified issues related to the application of the LIFO (last in, first out) method. According to Section 6(1) no. 2a of the German Income Tax Act, taxpayers who use the accrual method of accounting to calculate their profits may assume, for the purposes of valuing similar types of economic goods in their inventories, that the most recently purchased or manufactured economic goods will be used or sold first, insofar as this complies with the principles of proper financial accounting.

Under the LIFO method, similar types of goods, or functionally identical goods are grouped together and valued. The method does not have to correspond to the actual order in which the items are used or sold.

According to the Federal Ministry of Finance (*Bundesministerium der Finanzen*, BMF), the LIFO method is consistent with the principles of proper financial accounting if, at the end of the financial year, full stock is taken of the quantities of the economic goods available (stocktaking) and if the application of the LIFO method, based on enterprise-specific conditions, results in a simplification of the valuation. In this respect, a review should be made to ascertain whether or not the valuation is indeed simplified, particularly with regard to the inventory control system, if the data for individual valuations are also easily accessible.

The BMF circular provides for the following particularities:

- Insofar as it is possible to determine the individual acquisition costs of commercial goods, without incurring additional expenses, the LIFO method is not permissible.
- The LIFO method may also be applied to products that are manufactured or processed by the enterprise, on account of the other costs of production (besides the individual acquisition costs), if electronic systems (and the corresponding data) are available.
- The LIFO method may only be applied to perishable inventories if these can be kept for at least one year.

» **Recommendation:** Before applying the LIFO method you should clarify which data can be provided by the inventory control system and whether or not the LIFO method actually does constitute a simplification. In view of the stricter rules for perishable inventories, food processors, in particular, should review their valuation. Please do not hesitate to contact your PKF consultant for advice.

» **More Information:** The above-mentioned BMF circular from 12.5.2015 can be found online at www. bundesfinanzministerium.de (German version only).

CORPORATE FINANCE

International business poses risks for medium-sized enterprises

Who for: Enterprises that are planning to internationalise their business, or ones that would like to optimise their foreign activities.

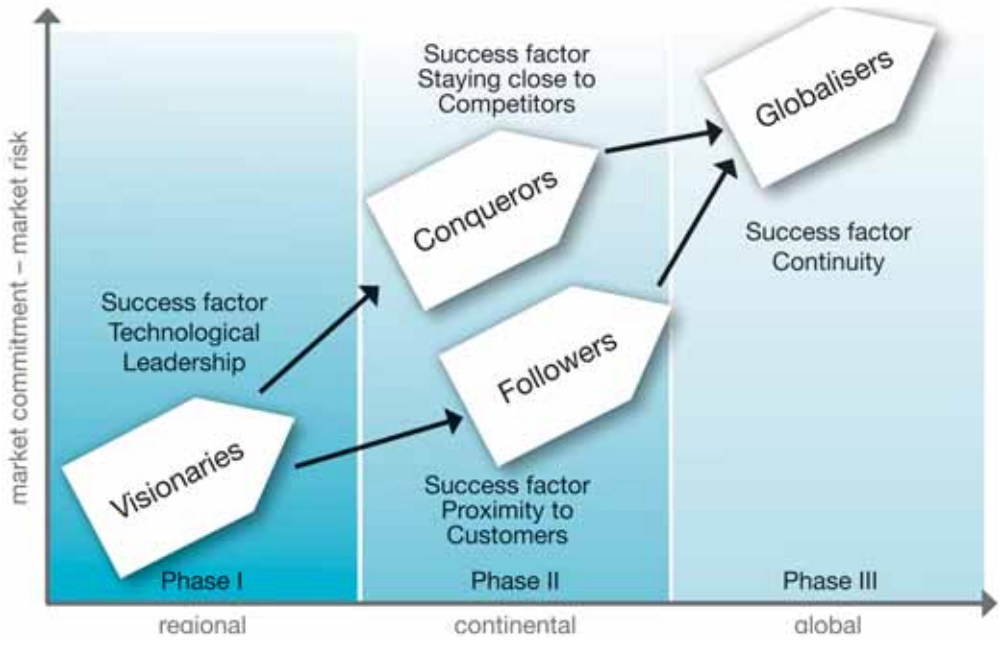
Issue: For small and medium-sized enterprises (SME), internationalisation also opens up opportunities for growing by diversification of sales markets and to enhance competitiveness. However, at the same time, internationalisation poses substantial challenges for SMEs because, frequently, the sales potential is in countries where, due to the economic, political and cultural differences, doing business is complex and risky. In the following section, we describe the potential internationalisation strategies on the basis of a phase model. Here, we were able to identify three phases that are characterised by the main factors of the geographical scope of the international involvement as well as the extent of market commitment and the market risk associated with it.

(I) Visionaries with technological leadership – Visionaries who aim at technological leadership try to establish long-term global "market-oriented innovation" and an "above-average development in countercyclical competence". Launching technologically superior products that are, nevertheless, always adapted to customer demands constitute an integral part of their innovative capacity. In the first phase, internationalisation is characterised by two main aspects, firstly, gathering successes and, secondly, testing by offering services in a known region without incurring unmanageable risks in the process. That is why visionaries favour immediate border regions for their forays into international markets. Besides pure export strategies, they prefer distribution deals and licences.

- **Risks –** Already during the first phase, which is actually a preparation for internationalisation, the risks should be limited. If having an international presence becomes a matter of prestige then, frequently, the strategic aspects of evaluating and selecting markets as well as the search for the right way to cultivate a market are neglected. Another risk is the unreflected pursuit of an international vision that has only recently been created. These two aspects, in conjunction with a lack of international experience, can lead to an approach to internationalisation that is not sufficiently systematic.

(II a) Conquerors who stay close to their competitors – Conquerors aspire to a higher pace of innovation than their competitors, or they try to gain a competitive edge, e.g. by providing outstanding service. Conquerors have a particular focus on technologically sophisticated markets that are geographically and culturally far removed. In doing so, they rely on the learning effects of being in competition and, in this case, profitability aspects are secondary in importance.

- **Risks** – Regular trips abroad by the top management will be unavoidable. This calls for important responsibilities to be delegated at head office, which frequently gives rise to the problem of overburdened middle management. Moreover, in the starting phase, locals are rarely hired for management positions and, consequently, managers are seconded abroad and, in the home country, replacements have to be found for qualified employees. Incorrectly assessing the local competition poses a further risk.



Phases of internationalisation of medium-sized enterprises

(II b) Followers with proximity to customers – In contrast to the "go-it-alone" strategy of the conquerors, followers are characterised by the coupling of their internationalisation strategy to the plans of their most important customers. The followers' mantra appears to be: "if we receive actual orders from customers then we will follow them worldwide". Similar to the conquerors, for followers internationalisation is, to a large extent, also dictated from the outside by customers. Against the backdrop of a lack of international experience and insufficient resources, followers cultivate markets primarily through co-operations.

- **Risks** – By internationalising in the immediate vicinity of the most important customers, initially, followers do indeed have a guaranteed source of sales. However, the risks are in the heavy dependence on the customers. Selecting foreign markets in a way that is relatively unstructured leaves little scope for your own strategic deliberations. Launching in several markets together with a customer requires the appropriate financial backing, which is frequently not available. If capitalisation is weak, then this can turn into a risk that threatens the survival of the company. The biggest challenge here is safeguarding a company's own identity and strength within a cooperation.

(III) Globalisers with continuity – Globalisers are active in the most important traditional markets in Europe, Asia and the USA. A global presence results in the need to leave the original niche in favour of diversifying the offering in order to continue to maintain international competitiveness

- **Risks –** Frequently, this need overburdens the SME's resources and, therefore, is only a suitable strategy in exceptional cases.

» **Concluding Recommendation:** As a rule, SMEs are only successful in foreign markets if they have, first of all, successfully demonstrated their capabilities in the domestic market. Internationalisation, therefore, is not a suitable way of compensating for failures in the home country. Only SMEs with business models that have been well proven in their home markets should pursue an internationalisation strategy. In the course of this, SMEs should initiate their international activities in border regions and, if appropriate, expand further from there.

AND FINALLY…

"Whether you think you can, or you think you can't – you're right."

Henry Ford (1863 – 1947), American industrial magnate

Impressum

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