

Editorial

Dear Readers,

In accordance with the “management approach”, stakeholders expect information on the same basis as the one that the management uses for its decision-making. Consequently, the disciplines of internal and external accounting are increasingly growing together. In the Focus section, we present the key points as to how **enterprise controlling** can be organised in order to complement external accounting.

The three contributions in the Tax section revolve around the arbitrariness of the tax authorities. A properly structured **apportionment of the purchase price** generally has to be accepted by the tax authorities. However, non-acceptance is the focus of the second article where there is a description of how the tax authorities understand their interpretation of what constitutes a **permanent establishment**. The third contribution is a discussion of the conditions for the retroactive correction of an invoice under which additional interest between the date of the invoice and the date on which it was corrected now no longer have to be accepted.

Social security law follows a barely comprehensible logic with respect to the **employment of students and interns** and that is why, in the Legal section, we have provided you with a presentation of the most important principles. In the second article, there is a discussion of the **problem with conditions precedent**, based on a recent case. While it is not always possible to avoid such conditions, however, they can have undesired consequences if significant events fall between the cut-off date in accordance with the German Law of Obligations and the real cut-off date.

Beta factors are not some sort of vitamins but are, however, of considerable significance when valuing a business. Their impact is frequently underestimated and, thus, reason enough to provide you with a summary, in our “Corporate Finance“ series, of the advantages of and the method for calculating them specifically for a company.

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

Your Team at
PKF

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FOCUS

Enterprise controlling in medium-sized companies – Better decisions thanks to better evaluations

Tax advice is usually based on data from external accounting, in particular, from the annual financial statement. However, the data basis for controlling is internal accounting, above all, cost and activity accounting. In recent times, the once strict separation between external and internal accounting has increasingly dwindled. Enterprise controlling is viewed as the integration of external and internal accounting in order to generate the advantages that ensue from decision-making with a better-substantiated informational foundation as well as those from transparent reporting.

1. Enterprise controlling – Accounting and planning move closer together

In practice, enterprise controlling is of high importance for medium-sized companies. A company's management and its shareholders expect decision-relevant information about future developments on the basis of which they should be able to get an idea of the overall situation of the business and check whether or not there is compliance with certain requirements regarding performance and financing targets. The information is based, above all, on the data from internal accounting. Moreover, the target readers of the external accounts – primarily, banks and other providers of debt capital but also institutional investors, tax authorities, analysts as well as rating agencies – also have a growing interest in internal data. They require projected balance sheets and other internal planning data in addition to the information in the annual financial statements, in particular, in connection with larger investment projects, corporate acquisitions and disposals. That explains the trend towards no longer viewing external and internal accounting as separate parts side by side but, in fact, integrating them. It is the task of enterprise controlling to reconcile the two sides.

The key performance requirement of enterprise controlling that is understood in this way is to develop a consolidated presentation of the future economic development of a business. This entails presenting the financial

position, cash flows and results of operations of the business within the scope of financial forecasts.

» **Interim result:** In this way, enterprise controlling pursues a cross-divisional and integrated approach and supplements classic controlling areas and instruments (sales forecasting, planning of production, personnel and materials as well as cost accounting, contribution margin accounting and variance analyses) with finance-oriented instruments from external accounting.

2. Implementing enterprise controlling

In the course of this, the established system of book-keeping and preparing of accounts is transferred to the new performance requirement when drawing up internally oriented projected balance sheets and projected P&Ls.

- In enterprise controlling, the analysis is carried out in accordance with the analysis of data from the annual financial statements and it is merely the time reference that changes.
- The projected net results are shown in the projected P&L that encompasses all the expenses and income of the business, including the accounts from external accounting.
- It may also be necessary to reconcile the results from controlling to those in the projected P&L (e.g. for imputed costs and neutral results).
- The results of the business planning are incorporated into a projected balance sheet and a projected P&L.
- Information from the external accounts about financial consequences (e.g. profit distributions to shareholders, tax payments) is included in the projected balance sheets and projected P&L in enterprise controlling.
- Drawing up internal projected balance sheets leads to enhanced informational value when compared with a conventional financial statement. Projected balance sheets show the effects of the forecast results on balance sheet items and balance sheet-driven performance indicators.

- The latter are used for internal corporate steering.
- Business results are reported regularly to external parties (e.g. banks) and to management on a monthly/quarterly basis with the planned and actual values in the management accounts and an analysis of the intra-year balance sheet.

3. Summary

Business financial projections have become increasingly important for strategic projects, such as corporate disposals and succession planning, and also for operational issues related to corporate financing as well as communication vis à vis lenders and shareholders.

Drawing up projected P&Ls and projected balance sheets in enterprise controlling and reporting the planned and actual values to external parties (e.g. banks) as well as to shareholders and to the management for the purpose of transparent reporting is, in the meanwhile, expected.

» **Recommendation:** A significant added value of enterprise controlling lies in clarifying, within the scope of financial projections, the effects on the balance sheet that would arise from decision alternatives and balance sheet policies.

- The decision-makers are informed at an early stage.
- Planning security is enhanced.
- The possible responses and the room for manoeuvre are highlighted in good time.

In order to optimise internal corporate steering and especially in the run-up to strategic projects, such as larger planned investments or corporate acquisitions and succession planning, in future, building up an appropriately structured enterprise controlling will be an absolute necessity.

TAX

Apportionment of the purchase price in a notarised agreement for the purpose of ensuring the tax-optimised depreciation of the building

» **Who for:** Owners and those who rent out properties.

» **Issue:** Frequently when a developed plot of land is purchased, the price for the plot of land itself

as well as for the building on it is certified by a notary in one single amount. As it is not possible to depreciate the plot of land itself, the acquisition costs have to be apportioned between the value for the building and that of the land. This always leads to disagreements with the tax authorities because the higher the depreciable amount for the building, the lower the tax liability.

With a view to making it easier to apportion the purchase price, and thus avoid disagreements, the tax authorities have developed a supporting tool. As a matter of fact, this tool frequently leads to unrealistically low values for buildings because the calculation is based on appraised values and averages. While the tax officers work with this tool they are however not necessarily bound by it, as its use is not prescribed by general administrative guidance. That is why taxpayers may refute the calculations if they can provide a different apportionment of the purchase price. Nevertheless, their objections have to be expertly justified but, in such cases, a valuation expert is not necessarily required. You may justify a different apportionment of the purchase price, for example, on the basis of a different indicative land value, normal production costs, or the standard of the fit-out.

» **Recommendation:** If the apportionment of the purchase price is set out in writing in the notarised agreement and if this has been done properly then the apportionment should be used to calculate the depreciation for the building. The tax authorities should generally accept the apportionment, unless it is illusory, or constitutes an abusive tax scheme (cf. German Federal Fiscal Court, 16.9.2015, case reference: IX R 12/14). In order to document the apportionment of the purchase price it would be advisable to keep the documents that show how the purchase price was apportioned.

Attribution of profits to permanent establishments – New administrative principles regulate who has to observe what

» **Who for:** Domestic (German) taxpayers with foreign permanent establishments and foreign taxpayers with domestic (German) permanent establishments.

» **Issue:** With the Ordinance on the Attribution of Profits to Permanent Establishments (*Betriebsstättengewinnaufteilungsverordnung*, BsGaV), from 13.10.2014, the legislature regulated in more detail the method for



Allocation of income raises many questions about delimitation

the delimitation of profits of permanent establishments that was developed at the level of the OECD (cf. issue 12/2014 of the PKF Newsletter). On 22.12.2016, the Federal Ministry of Finance (*Bundesministerium der Finanzen*, BMF) published the Administrative Principles for the Attribution of Profits to Permanent Establishments (*Verwaltungsgrundsätze zur Betriebsstättengewinnaufteilung*, VWG BsGa). The most important aspects (from the 186 pages!) are:

- The underlying statutory provisions are regulations for making adjustments to income that work in the favour of the German tax authorities in both outbound as well as inbound cases.
- Where there are DTAs, the regulations shall apply only if there is also a permanent establishment within the meaning of the DTA. Under the terms of tax treaties, the concept of a permanent establishment is narrower than under German tax law, i.e. the existence of a permanent establishment and thus the application of the VWG BsGa are less common.
- The principles do not apply if the permanent establishment is in the form of a partnership.
- For the auxiliary calculation, which has to be prepared at the start of the financial year, there is no connection to the balance sheet as the allocation of the endowment capital as well as the liabilities happens repeatedly at the start of each year.
- A detailed explanation of the different methods for determining the endowment capital for domestic and foreign permanent establishments by means of examples and, in some cases, simplifications are permitted.
- For low-risk service permanent establishments the use

of the cost mark-up method is generally envisaged. In practice, this includes, in particular, building sites and construction/assembly companies but also other permanent establishments that merely carry our routine work for a head office.

- In the case of a permanent establishment that is a building site or a construction/ assembly company, it is the view of the BMF that the cost and activity accounts for the construction project should be considered as the basis for the auxiliary calculation.
- For the use of DTAs with OECD states it is generally assumed that the other state recognises the German statutory provisions as well as their interpretation by the administration. For DTA

conflicts that occur nonetheless the BMF refers taxpayers to the mutual agreement procedure.

- With respect to the application of DTAs with non-OECD states, the regulations from the permanent establishment decree from 24.12.1999 are still valid.

» **More Information:** The VWG BsGa can be viewed at www.bundesfinanzministerium.de. (German version only).

Conditions for the retroactive correction of an invoice – Make use of the extended powers

» **Who for:** Businesses with a right to deduct input tax.

» **Issue:** Only a proper invoice authorises to claim input tax deduction. If an invoice does not fulfil the conditions in Sections 14 and 14a of the German VAT law then it has to be rejected or possibly corrected. In its latest decisions, the Federal Fiscal Court (Bundesfinanzhof, BFH) adopted the recent ECJ ruling and decided that the correction of an invoice would have a retrospective effect to the original date of the invoice and the first-time deduction of input tax. Therefore, in the case of subsequent objections to the input tax deduction, in the future, these will no longer result in additional tax payments together with interest insofar as the conditions for the retroactive correction of an invoice have been fulfilled.

It is the view of the BFH that in order to be able to correct an invoice it has to contain the following information:

- Issuer of the invoice
- Recipient of goods or services

- Service description
- Consideration
- VAT charged shown separately

A situation where an invoice should be corrected would arise, in particular, if the addresses of the concerned parties were incomplete, or if the invoice number was wrong or missing, or if the tax number was wrong or missing. It should be discernible from the re-issued invoice that it is one that has been corrected.

There is a good chance that, within the scope of a tax audit, the retroactive correction of an invoice can prevent temporary additional income and the running of interest. Nevertheless, invoices should continue to be strictly monitored, as only the issuer of an invoice is able to carry out the corrections. Businesses with a right to deduct input tax bear the risk of the issuer of the invoice being no longer available.

» **Recommendation:** The courts have not yet clarified the correction of invoices for substantive reasons. That is why an analogous application of these guidelines and a suspension of proceedings should be requested until the BFH has made a decision in this respect.

» **More Information:** The BFH rulings from 20.10.2016 can be found under case reference V R 64/14 and V R 26/15 at www.bundesfinanzhof.de. (German version only). The decisions relate to the basic ruling of the ECJ in the Senatex GmbH judgment from 15.9.2016 (case reference: C-518/14).

LEGAL

The employment of students and interns – Special features of German social security law

» **Who for:** Businesses and freelancers that employ students and interns.

» **Issue:** The assessment of the employment of students and interns under social security law is unclear and this is a field that is frequently under the scrutiny of the *Deutsche Rentenversicherung* (German Federal Pension Scheme). It is possible to classify students and interns according to the following main features:



The Intern generation from the perspective of the social security law

(1) Students (enrolled) – Students who are employed for a short time only (max. of 3 months, or 70 working days) are exempt from insurance in all the social security branches irrespective of working times and the amount of remuneration. For any work over and above this, students are exempt from insurance for healthcare, long-term care and unemployment, insofar as their course of study continues to be their main focus. This is presumed to be the case if the student works for no more than 20 hours per week during the semester holidays and/or during the semester. However, with respect to the statutory pension scheme, the normal compulsory insurance cover is applicable, whereby the employer and employee each pay half of the contributions. If the 20 hours per week limit is exceeded then there is an obligation to have social cover in all the branches.

(2) Interns – A distinction has to be made between a compulsory internship – a requirement under the regulations for a vocational training course, a study programme or examinations – and a voluntary one. For the latter, the general social security regulations are basically applicable, including the above-mentioned features for students. However, compulsory internships are included under types of working within the scope of company-based vocational training, which is why, e.g., the regulations on “marginal” part-time/short-term workers are not applicable. Furthermore, a distinction has to be made as to whether it is an interim internship or a pre/post-study one. A mandatory interim internship is exempt from insurance in all the social security branches, irrespective of the duration, the working times and the remuneration that is paid. A mandatory pre/post-study internship – therefore, without student status – is however subject to compulsory insurance in all the

social security branches. The defrayal of the contributions depends on the remuneration that is paid. If no remuneration is paid then the employer pays small lump sums for unemployment insurance and into the statutory pension scheme. If the amount of remuneration is below € 325 then the employer alone defrays the full amount of contributions to all the social security branches. If the amount of remuneration is above € 325 then the general rules are applicable with the employer paying half of the contributions; there is no sliding scale rule here.

Transfers of interests in a German limited partnership – Undesired consequences with conditions precedent as a(n) (avoidable) risk

» **Who for:** Family enterprises and their advisers.

» **Issue:** A business owner transferred a part of an interest in a limited partnership to his child for no consideration by way of an anticipated inheritance succession. The transfer took place in accordance with the German Law of Obligations as at 31.12.2008. The contract, which was concluded in December 2008, contained a provision that the taking effect of the transfer of the limited partnership interest would be contingent upon the child being entered as a limited partner in the commercial register. The submission to the commercial register was made on the same day that the transaction was officially recorded. The child was entered as a limited partner in the commercial register in January 2009.

The respective local tax office took the view that the relevant cut-off date for the assessment of gift tax was the date when the child was entered into the commercial register, therefore, January 2009. Therefore, the new inheritance tax legislation, in effect as of 1.1.2009, was applicable to the transfer.

The advisers to the family enterprise held the view that the old inheritance tax legislation was applicable. The date on which the agreement is concluded is the relevant one for the assessment of the cut-off date particularly as, in this case, this was also the date when the submission to the commercial register was made. The advisers further clarified that, in the past, in cases of transfers of property for no consideration the Federal Fiscal Court (*Bundesfinanzhof*, BFH) had not necessarily used the date of entry in the land register as a basis but, instead, the date on which all the declarations required for the transfer of

ownership had been submitted. The BFH now disagreed with this view. Such rulings about transfers for no consideration are exceptions and should not be used in this case. The principle that does apply is that it depends on the date of the actual contractual performance. According to Section 9(1) no. 2 of the German Inheritance Tax Act, the gifting is only concluded when the beneficiary has actually received what was supposed to have been transferred to him. Accordingly, this has to be based on the date when the condition is fulfilled, namely, when the entry is made in the commercial register.

The upshot was that the family enterprise was hit with a considerable tax bill that could have been avoided.

» **Please note:** In the case of under-age children, who should be represented by a supplementary guardian, many family courts only accept gifting contracts in order to avoid unlimited liability if the condition precedent of entry in the commercial register is agreed. Proceedings with the family court often lead to delays in the entry being made.

» **More Information:** The BFH ruling from 28.7.2015, as discussed here, (case reference: II B 145/14) has not yet been published.

CORPORATE FINANCE

Company valuation – Determining company-specific beta factors

The influence of beta factors plays an important role in the valuation of companies. For example, the beta factors that have been published for VW AG, according to the underlying index and time period, are currently between 0.83 and 1.94. Depending on other parameters, this could lead to a doubling or a halving of the company's value. Below we discuss how a company-specific beta factor is.

1. Definition of the concept of the beta factor

When calculating the value of a company on the basis of the income capitalisation or discounted cash flow methods, future financial surpluses are discounted to their present value by means of a discount rate. The discount rate consists of a risk-free interest rate and a risk premium, which in the perpetuity phase are supplemented further

by a growth discount. For the derivation of the risk premium, the general market risk is modified by the company-specific business risk – the so-called beta factor. This is a measure of the company-specific risk and describes the extent to which the value of a company fluctuates when compared with the overall market.

- A beta factor of 1 means that the value of the company fluctuates to the same extent as the overall market.
- With a value of < 1 a company's value is less volatile than that of the market, while with a value of > 1 the reverse is the case.

2. Calculating and interpreting the beta factor

Here, the company-specific risk consists of two components – the business risk and the capital structure risk (the debt situation). The beta factor is mathematically calculated on the basis of the

- covariance of a company's expected returns versus those for the overall market and the
- variance of the expected returns for the overall market.

(1) Derivation of the return for comparable companies – As exceedingly few companies are listed on a stock exchange, in order to calculate company-specific beta factors you have to draw on the development of returns for comparable companies listed on a stock exchange, the so-called peer group. This should include companies with business models that essentially match that of the company to be valued. The criteria are: the value chain, sales markets, company size, the structure of revenues and earnings as well as the general legal and political conditions.

(2) Derivation of the return for the overall market – The return for the overall market can be derived from the return of a share index (e.g. Dax, MSCI World, S+P 500 etc.). In the course of this, the benchmark index that is used should be the same one from which the peer group companies have been drawn.

(3) Derivation of regression lines – A company's returns and those of the capital market are entered into a coordinate system whereby the returns for the overall market are



A specifically calculated beta factor increases the figures of columns

transferred to the x-axis and the returns for the company to the y-axis. Using mathematical-statistical methods, a line (regression line) is drawn through the point cloud that is created in this way. The distances between the points should be as small as possible. The beta factor is then the slope of these lines that is calculated as the quotient obtained from the covariance of the company's expected returns and those of the overall market and the variance of the expected returns for the overall market. In order to evaluate the quality and significance of the regression lines and thus of the beta factor it is worth taking a look at the correlation coefficient - the closer this is to 1, the better the depiction of the point cloud by the regression line and the closer it is to 0, the weaker the correlation.

The longer the time period considered, the more meaningful the beta factor. By the same token, the currentness of the data is reduced as the period of time increases. The question that arises in connection with the time interval is the observation frequency of the pairs of returns; these can be recorded daily, weekly or monthly.

» **Recommendation:** It is usually not advisable to use industry sector betas, or ones that are published free of charge on the Internet because, for example, company-specific features are not taken into consideration in industry sector betas. In addition, in older overviews, beta factors fluctuate considerably over time. In any case, a blanket approach of using a beta factor of 1 does not lead to proper results. We recommend deriving a company-specific beta factor; when this has been calculated once then it can be subsequently updated with little effort.



Copyright and commercial intellectual property rights – Recommendations for taking into account the consequences of Brexit

» **Who for:** Businesses with cross-border activities for whom intellectual property rights are important.

» **Issue:** The free movement of goods is one of the fundamental freedoms of the EU’s Single Market. Customs duties have been eliminated and there are no quantitative delivery restrictions. For the realisation of the Single Market, EU Trademarks and Community Designs, among other things, were introduced for the protection of intellectual property. When the United Kingdom (UK) leaves the EU, it is possible that trade with the UK may no longer be protected. For three areas the consequences and recommendations can be depicted as follows.

(1) The movement of goods within the EU – A product produced by the owner of intellectual property rights or copyright and put on to the market by him/her, up to now, may be freely resold in the entire EU area. After Brexit, the

regulations on European intellectual property rights will no longer apply in the United Kingdom. Therefore, products put on the market in the UK will no longer be protected. Moreover, supplies from the remaining EU members can only be delivered to the UK if the local owner of intellectual property rights consents to this.

(2) Trademark rights – EU Trademarks and Community Designs ensure the validity of trademark rights within the EU. Brexit could make it necessary to register national British trademarks. Subsequent registration of a national design in the UK would probably be difficult. For new registrations you should also consider a registration in the UK.

(3) Licences – If the agreed scope of licence usage is “EU territory” then licence usage in the United Kingdom will cease. Supplementary agreements might possibly have to be negotiated. Moreover, the provisions in the licence agreements relating to tax, customs duties and compliance with regulatory requirements might possibly need to be revised in the context of Brexit.

AND FINALLY ...

“Of the five most important things in life, health is first, education or knowledge is second, and wealth is third. I forget the other two.”

Chuck Berry, rock 'n' roll pioneer and legend, 18.10.1926 – 18.3.2017

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