

## Editorial

Dear Readers,

Despite – or precisely because of – the current unpredictability of tax developments in the USA it is worth taking a look at the US tax system. In the ‘Focus’ section of the June edition of our newsletter, we discuss how the **check-the-box** option can optimise the tax position of different legal structures.

In the ‘Tax’ section we deal with two special topics. In the first report, you can find out about the requirements of the new **Union Customs Code** according to which authorisations that date back to the time of the previous customs code have to be reviewed. Then, in the second report, you can read that for many taxpayers it would be worth checking whether or not they are able to **offset losses from investment income against profits** even if these were partially subject to withholding tax and standard tax.

Our ‘Accounting’ section deals with a Federal Fiscal Court ruling that should be borne in mind for **sale-and-lease-back arrangements**.

**Living wills** can help to take somebody’s final wishes into consideration. For these to be valid it is necessary to adhere to certain rules and you can find out more about this from a Federal Court of Justice ruling that is discussed in our ‘Legal’ section. Board members and managing directors also need certainty. In the second report you can read about when it would be advisable to obtain a **fairness opinion** by a public auditor.

Warren Buffett is not the only investor to have made a fortune with **value investing**. In the ‘Corporate Finance’ section, we present this investment model which has been developed further, in theory and in practice, over the years.

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

Your Team at

PKF

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FOCUS

# Check-the-box as a fine-tuning instrument when choosing the optimum form of taxation in the USA

In Germany, taxation is strictly governed by the legal form and the subdivision into corporation and income taxes. By contrast, in the USA, the classification of companies for tax purposes is basically carried out independently of their classification under company law. In the course of this, the “check-the-box (CTB)” option is of great importance.

## 1. Legal forms in the USA

There are a large number of legal forms to choose from for the formation of a US business. As in Germany, these can be broadly divided.

- Entities organised in a corporate form include the Corporation (Corp., Inc., comparable to an AG [a German joint stock company] or a GmbH [a German limited company]).
- Unincorporated entities include, among others, the General Partnership (GP, comparable to an OHG [a German general partnership]), the Limited Partnership (LP, comparable to a KG [a German limited partnership]), the Limited Liability Partnership (LLP) and the Limited Liability Company (LLC).

## 2. Transparency, opacity and CTB

Irrespective of the legal form, for tax purposes a distinction is made between transparent and non-transparent companies.

- Transparent companies - Taxed as unincorporated entities and the income from them is attributed to the shareholders/partners.
- Non-transparent companies - Taxed as autonomous legal persons or entities that are subject to US corporate tax.

All the above-mentioned unincorporated entities may elect to be non-transparent for tax purposes. A corpora-

tion may be transparent for tax purposes if it is a so-called ‘S Corporation’ (restricted to US shareholders).

This is also referred to as a “check-the-box” (CTB) election because it can be made simply by ticking the appropriate box on form 8832.

## 3. Principles of taxation in the USA

Under the US system of taxation, income is subject to a Federal Tax and a State Tax. This system is applicable irrespective of what the legal form or mode of taxation is or was elected (CTB).

### 3.1 Taxation as an unincorporated organisation or a transparent entity

As it is possible, literally, to “see through” a transparent company, ultimately, for taxation purposes it is the type of shareholder that is crucially important. In the case of foreign natural persons (e.g. ones based in Germany), their rate of income tax at the Federal level will be up to 39.6% and at State level up to 12.3% depending on the

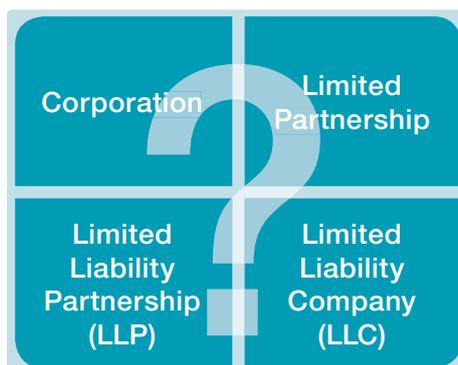
Federal State in which the company is taxable.

Under the Germany/USA DTA, the profit that is attributable to natural persons or companies based in Germany is basically exempt from taxation; however, in Germany, it would be subject to the exemption-with-progression rule.

If, from a US tax perspective, the shareholder is an opaque company then it will be required to pay US corporation tax.

### 3.2 Taxation as an entity organised in a corporate form or an opaque entity

If the taxation is based on the principles for entities organised in a corporate form and, therefore, the tax treatment



Important legal forms in the USA

is as for a non-transparent legal person or entity then the income at company level would be subject to US corporate tax. The combined US rate of corporate tax is, on average, approx. 40%. Another tax is levied at shareholder level if the company pays out dividends to the shareholders. Profit distributions to shareholders based in Germany are basically subject to a national US withholding tax of 30%. Under the DTA, a reduced rate of withholding tax of 5% is applicable in the case of a holding interest in a corporation of at least 10%, and a stake of 15% for all other legal structures. In the case of a holding interest of at least 80%, under certain other conditions, the rate of withholding tax may be lowered to 0%.

In Germany, only natural persons may credit withholding tax (in Germany the rate of withholding tax is 25%). In the case of corporations (shareholdings of 10% and above) withholding tax may not be credited because their dividends are tax-exempt.

#### 4. Is an LLC the ideal legal structure?

The overall tax burden should be taken into account when choosing the legal form and the tax structure. If the dividend is taken into account right down to the level of the German shareholders then the tax burden will be lowest for a purely unincorporated organisational structure. However, when compared with entities organised in a corporate form, there remain (more) risks under liability law.

Therefore, in practice, it has become very popular to form an LLC (Limited Liability Company) in order to benefit generally from the range of possible advantages under company law as well as tax law. Under US law, an LLC is regarded as being an unincorporated entity, or transparent, but the shareholders have only limited liability. With the CTB method, for tax purposes, an LLC is treated as a corporation, or a non-transparent entity. As there is no legal structure in Germany that is comparable to an LLC, for the classification for tax purposes - based on the respective Federal Fiscal Court (*Bundesfinanzhof, BFH*) ruling - a type comparison is carried out.

In this case, the German viewpoint is unrelated to the option selected in the USA. In a circular from 19.3.2004, the Federal Ministry of Finance (*Bundesministerium der Finanzen, BMF*) defined criteria on the basis of which it can be determined if a company structure that does not exist under German law is more similar to an entity

organised in a corporate form or to an unincorporated entity.

» **Please note:** The desired classification of an LLC as an unincorporated entity under German tax law, in order to minimise tax, depends therefore, in individual cases, on the specific contractual arrangements. Consequently, inappropriate use of this legal form, or if it was previously not optimally structured, could indeed turn out to be a tax pitfall if, in the USA, the LLC is considered to be an unincorporated entity and, in Germany, the tax authorities deem it to be an entity organised in a corporate form. In such a case, there would be a risk of a tax burden of 55% because, in Germany, the US profits would not be tax-exempt but, instead, would be taxed like a dividend.

» **Recommendation:** Based on the choice of legal structure and, possibly, CTB, in order to achieve an optimal overall tax burden and, at the same time, to avoid tax pitfalls there should be a thorough review, beforehand, of the choice of the US company structure and its specific arrangements as well as any CTB election. Please do not hesitate to contact your PKF consultant in this respect.

## TAX

### Mail from customs in connection with customs authorisations - what should you do?

» **Who for:** Holders of customs authorisations.

» **Issue:** With the application of the new Union Customs Code (UCC) by the customs authorities the existing customs authorisations will expire or will have to be reassessed. A distinction has to be made between:

**(1) Authorisations granted with a limited period of validity** – These include inward and outward processing, end use and temporary admission. These will generally cease to be valid as of 30.4.2019, or they will be revoked as at 1.5.2019 if their validity runs beyond 1.5.2019.

**(2) Authorisations granted with an unlimited period of validity (existing authorisations)** – These include, among others, authorised economic operator (AEO), authorised exporter and deferred payment. These will be valid until their reassessment has been completed - this will be carried out on the basis of checks by the Principal

Customs Offices (“self-assessment questionnaires”). In terms of content, the reassessment will involve a review as to whether or not these authorisations comply with the authorisation criteria of the UCC. In this case, the reassessment will be carried out in two steps. First of all, authorisations granted with an unlimited period of validity will be reassessed where this will not lead to any drawbacks for the holder of the authorisation.

Authorisations granted with an unlimited period of validity that, in accordance with the UCC, will be subject to stricter requirements than previously after the transitional period expires on 1.5.2019 (e.g. a guarantee for authorisations for storage facilities or customs warehouse) are only expected to be reassessed uniformly on a nationwide basis by 1.5.2019.

» **Recommendation:** Holders of authorisations with a limited period of validity should file a new application in good time before the validity period expires. Holders of authorisations with an unlimited period of validity should carefully complete the above-mentioned questionnaire and, if required, contact one of the PKF customs experts.

» **More Information:** You can find further information on the German customs website ([www.zoll.de](http://www.zoll.de)) under the section headings *Fachthemen Zölle* (Specialist Subjects Customs) (German version only).

### Loss relief in the case of negative income from capital assets, on which withholding tax has been levied, by way of an assessment on the basis of the most favourable provision for the taxpayer

» **Who for:** Taxpayers who generate income from capital assets.

» **Issue:** It is the view of the Federal Ministry of Finance (*Bundesministerium der Finanzen, BMF*) that losses from investment income that are subject to withholding tax should not be set against positive income that has to be taxed at the ordinary rate of income tax. In a recent ruling, the Federal Fiscal Court (*Bundesfinanzhof, BFH*) disagreed with this view taken by the tax authorities and it considers this type of offsetting to be permissible if the

taxpayer applies, in good time, for an assessment on the basis of the most favourable provision for the taxpayer (referred to in German as *Günstigerprüfung*).



The UCC requires a review of existing authorisations

In the case in question, the claimant had generated, among other things, interest from a private loan that had to be taxed on the basis of the standard progressive rate. Moreover, the claimant recorded negative income from capital assets that was basically subject to withholding tax. The claimant had applied to offset this capital income by way of an assessment on the basis of the most favourable

provision for him. The local tax office and the tax court rejected the offsetting.

The BFH then upheld the claimant’s view in this respect whereby he believed that setting off the losses against investment income was permissible on the grounds that he had filed an application for an assessment on the basis of the most favourable provision for him. Indeed, this application resulted in the negative investment income that was liable to withholding tax becoming subject to the standard rate of income tax so that it then became possible to offset the loss. However, the BFH rejected the claimant’s additional demand to be able to deduct the saver’s allowance from the positive income from capital assets that was taxable at the standard rate of tax.

» **Recommendation:** An application for an assessment on the basis of the most favourable provision for the taxpayer can be advantageous if, at the same, this gives rise to negative income from capital assets that is subject to withholding tax and positive income from capital assets that are subject to the standard progressive rate of tax. An application for an assessment on the basis of the most favourable provision for the taxpayer may be filed until the notice of income tax assessment becomes incontestable. If necessary, you should lodge an objection to a notice of income tax assessment where, despite an application for an assessment on the basis of the most favourable provision for the taxpayer, the tax authority has refused the offsetting of losses.

» **More Information:** The above-mentioned BFH ruling from 30.11.2016 (case reference: VIII R 11/14) is available at [www.bundesfinanzhof.de](http://www.bundesfinanzhof.de) (German version only).

## ACCOUNTING

### Economic ownership in the case of sale-and-lease-back transactions with a sellback right

» **Who for:** Businesses with hidden reserves in their fixed assets that want to enhance their balance sheet or liquidity situation, or make use of loss deductions.

» **Issue:** A so-called sale-and-lease-back transaction is one where assets are sold to a leasing company and profits are realised in the process and, subsequently, within the scope of a leasing transaction, the seller continues to use the assets. In order for this arrangement to be recognised for tax purposes it is crucial that the economic ownership is transferred from the seller, or the lessee, to the lessor.

In the following group of cases the economic ownership – despite a different ownership situation under civil law – remains with the lessee and prevents recognition:

- (1) speciality leasing (property is specifically tailored to the circumstances of the lessee);
- (2) the normal period of the useful life and the basic lease term are approximately equal;
- (3) the lessee has the option to extend or buy on favourable terms.

A sellback right means that, upon expiry of the agreed term, the lessor has the right to offer the leased property to the lessee for purchase. In such a case, the lessee has to acquire the property that has been offered.

In a ruling from 13.10.2016, the Federal Fiscal Court (*Bundesfinanzhof, BFH*) had to clarify the issue of whether or not an economic ownership is transferred to the lessor if the latter, from its own perspective, only has a favourable sellback right. The court of first instance had viewed this as being sufficient because with commercially prudent decision-making it would be likely that the right would be exercised. By contrast, the BFH emphasised the “primacy of accounting for the owners under civil law”. For the exceptional case of beneficial ownership there would have to be an ownership-like legal position. According to section 39(2) no. 1 of the Fiscal Code of Germany, it is necessary for “another person” (in this case the lessee) to be able to exclude the owner under civil law from affecting the economic good during the normal period of its useful life. However, upon the expiry of the basic lease term, the lessor, with its sellback right, would be able to treat the economic good as it sees fit. At all events, the

beneficial ownership of the lessee as per case group (2) could therefore arise.

» **Recommendation:** The desired attribution of the leased property to the lessor can be ensured by agreeing a sellback right for the lessor instead of an option for the lessee. However, this harbours the risk that the lessor will not act as the lessee wishes.

» **Please note:** With sale-and-lease-back transactions you should also pay close attention to the assessment for the purposes of value-added tax. This is based on actually obtaining control over the authority to dispose of the asset. If the structure of the agreement is aimed primarily at the financing of the leased item then this would be deemed to be tax-exempt lending (cf. BFH ruling from 6.4.2016, case reference: V R 12/15).

» **More Information:** The above-mentioned BFH ruling, from 13.10.2016 (case reference: IV R 33/13) is available at [www.bundesfinanzhof.de](http://www.bundesfinanzhof.de) (German version only). Other similar cases that are still pending at the BFH have the case references: IV R 55/16 and 56/16. Admittedly, the Cologne tax court, as the court of first instance, in its rulings from 1.9.2016, used guidelines that are now obsolete as the starting point for its evaluation of sell-back rights.

## LEGAL

### Requirements for living wills

» **Who for:** People who have laid down, or want to lay down a living will.

» **Issue:** The Federal Court of Justice (*Bundesgerichtshof, BGH*) fleshed out the conditions attached to a binding living will in its ruling from 8.2.2017 (case reference: XII ZB 604/15). If a person who is receiving care is in a situation where the discontinuation of life-sustaining measures is being contemplated then, in order to make such a decision, the representative of this person will generally require approval from a special adult guardianship court (Section 1904(2) of the German Civil Code). This approval is not required if there is a binding living will. It is then incumbent on the patient’s representative not to make his/her own decision but, instead, to express and apply the will of the person concerned.



Is your living will still valid?

In its ruling, the BGH made it clear that a living will have an immediate binding effect if it makes apparent both the medical interventions as well as the specific situations in which the living will should become applicable. General statements alone (such as “life-prolonging measures should cease”) would not satisfy this requirement for clarity and definiteness. It is only in combination with other information that such a general statement can have a binding effect. However, the BGH does acknowledge that the requirements with respect to the principle of clarity and definiteness should not be overstretched. It is, therefore, sufficient for the person concerned to write down a description of the situations.

» **Recommendation:** Anyone who draws up a living will has to achieve a balanced compromise between specific descriptions of the desired medical interventions and the situations in which the living will should be applied. Moreover, authors of this document should also formulate things in an open way that would allow future (medical) changes and situations as yet unforeseen to be covered. People who have already created living wills should review them to see whether or not they satisfy the requirements of the BGH.

## Avoiding liability risks through fairness opinions

» **Who for:** Board members or managing directors who make decisions with far-reaching consequences (in particular, the acquisition or sale of businesses).

» **Issue:** If, retrospectively, a business acquisition or the sale of a business turns out to have been a bad deci-

sion then this could lead to board members or managing directors being liable for this on the grounds of a breach of their duty of care. According to the ‘business judgement rule’ in the German Stock Corporation Act, no breach of duty will be deemed to have occurred if, when making its business decision, the executive board could reasonably have assumed that it was acting on the basis of adequate information for the benefit of the company. According to a supreme court ruling, this provision shall apply accordingly to the managing director of a *GmbH* (a German limited company). In order to ensure that adequate information is available it is necessary to carefully ascertain the basis for the decision and, in the course of this, to make full use of all the sources of information.

Therefore, in order to protect the executive board or the managing directors and to document the basis for their decisions during a corporate transaction it is recommended to obtain a fairness opinion from a public auditor. A fairness opinion is usually viewed as an adequate basis of information within the meaning of the business judgement rule. Furthermore, a fairness opinion helps to reduce information asymmetries between management and the supervisory body, or shareholders in respect of a corporate transaction.

A fairness opinion is understood to mean a statement by a public auditor on the financial reasonableness of an agreed or intended transaction price. Financial reasonableness exists if the transaction price that is being assessed lies within a range of values that have been determined using generally accepted techniques for valuing companies. A fairness opinion generally consists of an opinion letter and a valuation memorandum.

- In the opinion letter, the public auditor comments on the financial reasonableness of the transaction price.
- The valuation memorandum presents in detail the methods, specific approach and premises that were used as well as the results of the analysis behind the overall assessment.

» **Recommendation:** An ex-post evaluation could possibly result in values that differ from those that have already been communicated, therefore, in order to avoid this happening, a public auditor should be involved in the transaction process already at an early stage. In this way it would be possible to identify risks still before the acquisition and take them into account in the transaction price and/or in the sale and purchase agreement.

## CORPORATE FINANCE

### Further developments in value investing - The opportunities and possibilities of the modified valuation method

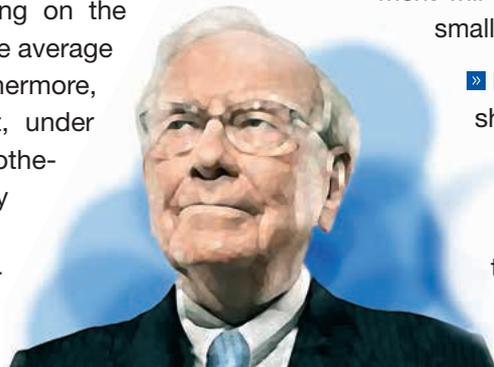
**“If you aren’t willing to own a stock for ten years, don’t even think about owning it for ten minutes. Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio’s market value.” This is a quote from Warren Buffett (cf. also ‘And finally ...’), who constructed his portfolio on the basis of so-called value investing.**

#### 1. Traditional Value Investing

Value investing denotes investing in stocks for the long term where buy and sell decisions are guided by the ratio of the current price to the value (thus their relationship). In this case, the price corresponds to the current stock price. On the basis of this strategy, investments are made specifically in stocks of companies whose current stock price appears to be low when compared with the intrinsic value (the assumption is that they are undervalued). The stock selection is carried out within the framework of a fundamental analysis. In the course of this, in a first step, “simple” valuation metrics are frequently considered such as, e.g., the price/earnings ratio (p/e), or the price/book value ratio (p/bv). Past performance plus current information are available to value investors in order to determine the ratio between the price and the value. This traditional method is based on the perfect market hypothesis.

#### 2. Further developments in the model

In the course of further development the perfect market hypothesis was abandoned. Recent empirical studies have shown that stock returns depend on growth, the return on equity and the probability of insolvency (rating). A rating, in particular, is at odds with the perfect market. Contrary to conventional notions, companies with a good rating on the stock exchanges exhibit above average risk-adjusted returns. Furthermore, research has confirmed that, under the imperfect market hypothesis, by buying fundamentally undervalued companies it is possible to generate significant risk-adjusted excess returns when compared with the market index.



On the road to Warren Buffett’s success with value investing?

#### 3. Potential for improvement and future development

The potential for improvements in value investing consists in the fact that, up to now, when determining the fundamental value of a company other major factors have scarcely been taken into account. Besides the rating, earnings volatility could also be analysed, for example. These and other considerations in respect of the premises of the imperfect market could be added to future models for the valuation calculation.

## IN BRIEF

### Extended deadline for submitting electronic tax returns for 2016

Employees for whom a tax assessment is mandatory and who already submit their tax returns to the local tax office via ELSTER, or who were registered under [www.elster.de](http://www.elster.de) by the end of May, have two more additional months time - up to the end of July 2017 - for the submission of their tax returns for 2016. This provision applies in Hesse, North Rhine-Westphalia, Bavaria and Baden-Wuerttemberg. Furthermore, taxpayers who had previously been required to submit their tax returns electronically (e.g. tradespeople, freelancers and landlords) may also benefit from the deadline extension.

### The limit for invoices for small amounts increased from € 150 to € 250 as of 1.1.2017

As of 1.1.2017, businesses that are authorised to make input tax deductions may retroactively claim an input tax deduction for invoices up to € 250 (gross) insofar as the conditions for invoices for small amounts, in accordance with Section 33 of the German VAT Implementing Ordinance, have been fulfilled (German Bureaucracy Reduction Act II). This adjustment will be advantageous, in particular, for the billing of small, frequently occurring cash transactions.

❏ **Recommendation:** Invoices for small amounts should only include mandatory information in accordance with Section 33 of the German VAT Implementing Ordinance because any additional information would harbour the risk that the invoice could turn out to be incomplete or incorrect and, thus, could jeopardise the input tax deduction of the recipient of the supply.



## Timetable for the British exit from the EU

On 29.3.2017, in Brussels, the United Kingdom handed over its notification of withdrawal from the EU. This was the beginning of the phase of negotiations about the conditions of withdrawal. Brexit should be completed within two years. According to the EU treaties, this deadline can only be extended with the agreement of the United Kingdom and all the other 27 EU States. According to the British Prime Minister, Theresa May, it will be a hard Brexit.

Following the notification of withdrawal, at the end of April, the EU heads of state and government met at a special summit in Brussels and agreed guidelines for the legal basis for the Brexit negotiations. Accordingly, the negotiations will have to proceed in two phases: first of all, the details of the withdrawal will be clarified so that, afterwards, the future relations between the United Kingdom and the EU states can be negotiated.

The negotiations about Britain's exit should be concluded by October 2018. To begin with, the EU would like clarity on Britain's financial obligations to the EU and an explanation with respect to the status of EU citizens living in the United Kingdom. It is estimated that 3.3 m EU citizens currently live in the United Kingdom and around 1.2 m Brits in the EU. Britain's financial obligations to the EU are estimated to be up to € 60 bn.

The agreements will have to be ratified by a qualified majority of the member countries and a simple majority of the EU Parliament by March 2019 so that Britain's exit can potentially be realised within the two year deadline.

It is unclear when the more comprehensive negotiations about the future relations between the United Kingdom and the EU will be concluded. If a free trade agreement is not concluded in good time then World Trade Organisation (WTO) rules will apply to the trade relationship between the EU and the United Kingdom. This would result in customs duties, among other things.

## AND FINALLY...

"In the short term the market is a popularity contest; in the long term it is a weighing machine."

**Warren Buffett**, born 30.8.1930, US American large-scale investor, entrepreneur and patron.

## Impressum

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