PKF

Accountants & business advisers

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Editorial

Dear Readers,

US Tax Reform is showing its first effects. In the middle of January, Apple's decision to invest billions of its group profits increasingly in the USA again created a big stir in Europe where, for years, the group has been granted generous tax breaks. However, it is not only US companies that will benefit. In the Focus section, we discuss the most important aspects of the US Tax Reform for **German export companies**.

There was also a reform in the **Gulf States**, however, the aim here was to increase tax revenues. Under 'Tax' you can read about the main features of the **value added tax system** which was introduced at the start of 2018 and will be gradually developed further. Then, in the second article on tax, we report on a positive court ruling according to which, in the unfortunate case of **losses on receivables in private assets**, these may at least be **offset against tax.**

The contents in this month's Legal section concern the strengthening of employees' rights. Firstly, we take a look at more **transparency** for the purpose of eliminating **wage and salary differences** that are too substantial and, subsequently, the **easier transfer of occupational pension rights** when moving to a new employer. Thereafter, we discuss the particularities of the **valuation of business assets** when calculating **compensation for accrued gains**. We round off our range of contents with an aphorism related to our introductory report on US taxes.

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

Your PKF Team

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LATEST REPORTS

Section 50d(3) of the German Income Tax Act contravenes EU law

A foreign parent company that receives profit distributions from its German subsidiaries may generally apply for an exemption from or a refund of the tax that has to be withheld at source (in accordance with the relevant DTA, or the Parent-Subsidiary Directive). Under Section 50d(3) of the German Income Tax Act (*Einkommenssteuergesetz, EStG*), the possibility of relief from withholding tax is subject to a restriction as it is tied to the condition of providing evidence of the foreign corporation having adequate economic substance. This is done in order to prevent the deduction of German withholding tax being circumvented through cross-border tax structuring measures (so-called treaty/directive shopping). Recently, the ECJ decided, in its ruling from 20.12.2017 (case reference: C-504/16 and C-613/16), that this regulation contravenes EU law to the extent that, with respect to the aim of preventing abuse, the irrebuttable presumption of abuse is disproportionate. This ruling was indeed issued with respect to a version of Section 50d(3) of EStG that only affects cases up to 2011. However, the same doubts exist for the current version of Section 50d(3) of EStG - where the rules were slightly eased and which subsequently came into force - that is still applicable today. That is why the outcome of a further case, which is currently still pending at the ECJ (case reference: C-440/17) is expected to produce a corresponding result.

Limitation on loss deduction for corporations

New rules are required for the partial non-recognition of a loss under Section 8c of the German Corporation Tax Act (*Körperschaftsteuergesetz, KStG*) in the case of the acquisition of shareholdings. Moreover, the Federal Constitutional Court (*Bundesverfassungsgericht, BVerfG*) has to decide on full non-recognition (cf. PKF Newsletter 10/2017) and, in doing so, include the "loss carry-forward tied to the continuation of the business" (cf. PKF Newsletter 1/2017). On 28.11.2017, the Federal Ministry of Finance published a circular on Section 8c of KStG. According to this, until new legal provisions are in place, the rule on the partial non-recognition of losses should not be applied, for the time being, to shareholdings in corporations that were directly acquired prior to 1.1.2016. We still recommend that you should lodge an objection against notices of assessment with limitations on tax loss deduction due to transfers of shareholdings of more than 25% and request a suspension of proceedings.

A single entity for income tax purposes will only be recognised if there actually is an entry in the Commercial Register

In the case of a single entity for income tax purposes, the earnings of a subsidiary company will initially be allocated to the parent company for the calendar year in which that subsidiary company's financial year ends and in which the profit transfer agreement comes into effect for the first time. The initial applicability of the profit transfer agreement depends, among other things, on it actually being entered into the Commercial Register. This applies even if, through no fault of the taxpayer, there is a delay in the course of applying for an entry in the register, e.g. because an authority has failed to act properly. Furthermore, any taxes levied for an assessment period as a result of a single entity not having yet been recognised for income tax purposes due to a delay in the entry in the Commercial Register may, moreover, not be waived on the grounds of substantive unfairness. This restrictive view of the tax authorities was recently confirmed by the Federal Ministry of Finance in its ruling from 23.8.2017 (case reference: I R 80/15).

Wording that deviates from the company/partnership agreement will be rejected

The Munich court of appeals (*Oberlandesgericht, OLG*) has ruled that a commercial register court may refuse to make an entry for the provision on representation if it differs from the one in the company/partnership agreement and was adopted on the basis of a simple (not officially recorded) decision. The reason given by the court in its ruling from 25.7.2017 (case reference: 31 Wx 194/17) was that there would be a permanent breach of the company/partnership agreement.

P.R. China - Withholding tax deferral for profit distributions

In its ordinance of 21.12.2017, the Chinese Ministry of Finance ruled that, with effect from 1.1.2017, withholding tax on dividends, bonuses and other income from investments in Chinese enterprises will be deferred retroactively for foreign investors and any withholding tax that has already been paid will be refunded. This is on condition that the profit distributions are directly reinvested in China. The tax concession applies especially to start-ups and the acquisition of equity in, or increases in shareholdings of Chinese enterprises. Further details can be found in the 'Catalogue of Industries for Guiding Foreign Investment' and the 'Catalogue of Priority Industries for Foreign Investment in Central and Western China'. Acquisitions of shares listed on a stock exchange as well as of equity interests in associated companies would not qualify for the concession.

FOCUS

US Tax Reform – A positive stimulus for German export companies

On 22.12.2017, the US President signed into law the biggest overhaul of the US tax code in more than 30 years. The aim was to simplify the tax system, reduce taxes, create incentives for investment in the USA and to bring about a positive stimulus for the jobs market and thus raise employment levels. From a business perspective, the significant reduction in the level of corporation tax from 35% to 21% (excluding local taxes) should be highlighted in particular. In the following section we present the most important changes from a business perspective, although the focus will be on the impact for German companies that export as well as businesses with US subsidiary companies.

1. Reduction in the rate for corporation tax

The rate for corporation tax will fall from previously 35% to 21%. Taking into account local taxes, the combined charge will thus be reduced to approx. 25% (depending on where the company is based). The reduction will come into effect from the start of 2018.

2. 'BEAT' instead of 'Border Adjustment Tax'

Border Adjustment Tax, which was still under discussion during the legislative procedure, did not become a feature of the tax reform. This would have vastly increased the price of exports into the USA by potentially not allowing US companies to deduct the cost of imports as a business expense. In return, however, a Base Erosion Anti-Avoidance Tax (BEAT) has been adopted. BEAT is supposed to prevent foreign companies reducing the profits of their US subsidiaries via intra-group contracts, such as for example, with respect to licensing and financing arrangements. Accordingly, the US tax based on an assessment under BEAT rules (i.e. after adding back certain payments to foreign group companies) may not fall below 5% (in 2018, by 2026 this will be increased to 12.5%). Otherwise, the tax liability will essentially be adjusted to this value via the BEAT provisions.

» **Please note:** Nevertheless, for the German Mittelstand (medium-sized companies), with its traditional strong export focus, this amendment, when compared with the previous drafts, should be seen as good news. This is because, firstly, the BEAT will only apply

- to corporations with annual revenues of US$ 500 m and,
- secondly, goods transactions (imports of goods from Germany) will essentially not be covered by the BEAT.

3. Switch to territorial system and fictitious profit repatriation

For US corporations that receive foreign dividends, a transition from the previous system of worldwide taxation - where foreign taxes that have been paid are credited - to a 'territorial' system is planned. In future, the foreign dividend income of US corporations should essentially be tax-exempt if the size of the shareholding is at least 10%. Gains from the sale of such a shareholding will no longer be subject to US tax.

» **Please note:** Transitional regulations will be required for foreign profits that were previously untaxed and for which US tax was postponed until the profits were repatriated to the USA. The law provides for a one-off back tax on these subsidiary companies' profits, not yet taxed since1986, at a rate of 15.5% (financial resources) and 8% (illiquid assets), although the tax payment can be spread over a period of eight years.

Tolerable BEAT provisions instead of comprehensive border adjustment tax

4. Immediate expensing options

In order to create a stimulus for investment, the law provides for certain qualifying assets, acquired up to the end of 2022, to be immediately fully expensed. As

of 2023, immediate deductibility for purchases will be reduced incrementally until 2026.

5. Limits on interest expense deductions

In the USA, the restriction on the tax deductibility of interest payments will, in future, be along the lines of the German interest barrier. Similar to this, as of 2018, net interest expense in the amount of just 30% of the 'adjusted taxable income' (this is akin to the 'German' Tax EBITDA in the context of the interest barrier) would be deductible.

6. Utilisation of tax loss carry-forwards

The concept of minimum taxation, already known from German tax law, has also found its way into US tax legislation in a similar form. From now on, a tax loss carry-forward can generally be carried over indefinitely. However, in return, loss carrybacks have been abolished and the use of losses has been limited to 80% of the taxable income.

7. Incentives for licence income

The pursued aim of the legislation is to create incentives for investments in the development of intangible assets (IP) and/or their use in the USA.

- To this end, firstly, the introduction of a preferential tax regime for foreign-derived intangible income is envisaged (e.g. licence income; effective tax rate of around 13%).
- Secondly, the 'shifting' of income that is realised from IP rights to subsidiaries that are based in low tax countries will be combated. To this end, certain proceeds from the offshoring of intangible assets will be included in the US assessment base and will be subject to tax at a rate of 10.5% in the USA.

8. Outlook

The reform is likely to go down in history as one of the biggest US tax reforms. In particular, the cut in the rate for corporation tax and what is ultimately a watered-down form of border adjustment tax will lead to a considerable reduction in the tax liability for the US subsidiaries of German companies and will, at least, not be detrimental for the German Mittelstand with its traditional strong export focus.

» **Please note:** However, it remains to be seen whether or not, from the German and European perspective, disadvantages will emerge in the long term from the potentially enhanced attractiveness of the USA as an investment location.

StB Dr. Jan Wendland

TAX

Value-added tax in the Gulf States from 2018

» **For who:** Companies that maintain business relationships with customers in the member states of the Gulf Cooperation Council ("Gulf States").

» **Issue:** In the past, VAT was not levied in Qatar, Saudi Arabia, Oman, Kuwait, Bahrain and the United Arab Emirates (UAE). Moreover, up to now, direct taxes were generally only payable on business profits, although individual states had refrained from imposing tax even on these, or had only taxed profits from businesses in specific industries.

In 2015, the Gulf States set in motion the process of introducing VAT. To this end, an agreement was concluded that defined a framework for the transposition into the respective national tax laws. At the same time, the agreement leaves the member states free to make their own specific national rules in certain areas. The new tax was introduced in Saudi Arabia as well as in the UAE as of 1.1.2018. The introduction in the other member states is planned for 2019 or 2020. VAT in the member states of the Gulf Cooperation Council is generally closely modelled on VAT in the EU.

Ultimately, through the system of input tax deduction at the company level, it is private consumption that is being taxed.

The supply of goods, the provision of services and the import of goods are all subject to VAT. Under the framework agreement, the standard rate of VAT is between 3% and 5%. In Saudi Arabia and in the UAE the standard rate of VAT has been set at 5%.

The member states have the option of exempting certain transactions from tax, or 'zero rating' them. This includes, in particular, services in the education, health, property and transport sectors. Exports are zero-rated.

The input tax deduction will be possible insofar as the initial supply was subject to the standard rate of VAT or the 'zero rate'. However, a tax exemption on the output side will usually preclude an input tax deduction.

The further parallels with VAT in the EU are that, in certain cases, the reversal of the liability for the payment of VAT could be envisaged and that there will be the option of forming a single entity for VAT purposes.

Furthermore, the member states of the

Gulf States are introducing a new VAT system

Gulf Cooperation Council also have the possibility of setting up so-called 'designated free zones'. This would be a delimited geographic area on the territory of one of the states that, for the purposes of VAT, would be treated as a foreign area. In the UAE, for example, there are currently 20 such free zones.

» **Please note:** Ultimately, the new regulations also provide for the refunding of input tax to foreign companies. It remains to be seen whether or not these rules satisfy the German requirements for so-called reciprocal treatment with the result that, in the reverse case, companies from these states would be able to apply for a refund of German input tax. So far, there have been no official statements from the German tax authorities in this respect.

StB Thorsten Haake

Default on a private loan receivable as a loss from capital assets

» **Who for:** Private individuals whose financial claims are left unsatisfied.

» **Issue:** Since 2009, gains and losses from the disposal of financial claims (e.g. arising from loans to a corporation) have been generally subject to income tax under the withholding tax system. However, this applies only to private claims from which income from capital assets is generated and not to (special) business assets. The Federal Fiscal Court (*Bundesfinanzhof, BFH*) recently ruled that, in the context of income from capital assets, it would also be possible to deduct a loss if, as a consequence of a debtor's insolvency, a financial claim is left unsatisfied and this loss has been definitively established. This could be the case, for example, if an application for the opening of insolvency proceedings was dismissed for lack of assets. Thus, the BFH has contradicted the tax authorities that, up to now, have rejected the tax deductibility of losses in cases where claims have been left unsatisfied.

» **Recommendation:** The loss is calculated from the difference between the proceeds from the repayment (minus the directly materially related expenses) and the acquisition costs for the financial claim. For specific cases, you should always check whether or not and to what extent a loss from capital assets can be deducted against income tax.

» **More Information:** The above-mentioned BFH ruling from (24.10.2017, case reference: VII R 13/15) is available at www.bundesfinanzhof.de. (German version only).

Isabee Falkenburg
WP StB Dr. Dietrich Jacobs

LEGAL

The German Pay Transparency Act is operational – Rights to information and reporting requirements

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

» **Issue:** Since 6.1.2018, the German Pay Transparency Act has established the individual rights of employees to information about the pay structures in a company. The aim is to eliminate the pay discrimination between men and women that currently exists ("equal pay for equal work"). The key regulatory areas can be distinguished as follows:

(**1) Companies and individuals affected –** The right to information exists only in businesses that usually employ more than 200 staff with the same employer. Furthermore, there has to be a group of at least six people of the other gender who carry out the same or equivalent work.

(2) Asserting the right – The right needs to be asserted in written form or via e-mail. If there is a works council then the employees have to approach it in this respect, otherwise they can directly contact the employer. In the case of largely unchanged circumstances, a renewed request for information can only be made after three years (as of 5.1.2021, every two years).

(3) Subject of the disclosure – The information that has to be disclosed should comprise the criteria and methods for setting remuneration for the work of the person requesting the information, or for equivalent work and, moreover, the median of the average pay for the peer group of the other gender. There are certain exemptions available for businesses that are subject to, or that apply collective agreements.

(4) Other obligations for large enterprises – In addition, private employers with more than 500 staff have to implement business auditing procedures that ensure that there is equal pay. Furthermore, they have to produce a report on equal opportunities and equal pay. This report will have to be included in the management report as an appendix and published for the first time in 2018 and, subsequently, every three or five years (respectively for companies subject to collective agreements/ companies that apply collective agreements). In the report, the employer has to provide a comprehensive description of the specific measures in place to promote equal opportunities as well as their impact.

What do my colleagues earn?

» **More Information:** The German Ministry for Family Affairs has published – on its website www.bmfsfj.de- guidelines for the Pay Transparency Act with classic examples and checklists for employers and works councils/ staff councils.

RA Frank Moormann

Occupational pension schemes – New vesting periods and adjustment obligations

In future, employees will be able to transfer their occupational pension rights more easily when they change employers. The reason behind this is 'the act to implement the EU mobility directive'. The changes arising from this to the Occupational Pensions Improvement Act (Gesetz zur Verbesserung der betrieblichen Altersversorgung, BetrAVG) came into force on 1.1.2018.

1. Shorter vesting periods for rights to occupational pension benefits

Rights arising from employer-financed pension schemes that are finalised as of 1.1.2018 will be vested already after three years if on the date that the employee leaves the company s/he is already 21 years old. This shorter vesting period will also apply to commitments concluded prior to this date, however, the period will only commence on 1.1.2018. In this way, in accordance with the purpose of the act, it will become easier to transfer rights when you move to a new company.

» **Recommendation:** In particular, employers with high staff turnover rates and a large group of employees who are under 25 years old, or who have not yet completed five years of service, should review the effects of the legislative changes on the basis of a forecast calculation.

2. Pension dynamisation obligation for vested pension benefits

In addition, for vested pension benefits that are acquired through employment after 1.1.2018, a further adjustment obligation arises in cases where employees who have left the company would otherwise be placed in a less favourable position than active employees (dynamisation).

However, this is excluded for pension commitments that are based on an occupational pension scheme that was already no longer open to new contracts prior to 20.5.2014.

3. Other obligations for employers

In future, moreover, employees will have greater rights to information. In addition, compensation for a minimum pension benefit in the event of a cross-border change of employer will only be possible with the employee's consent.

» **Recommendation:** Employers with pension commitments that were open to new contracts on 20.5.2014 should make various adjustments.

4. Accounting effects

In terms of accounting, attention should basically be paid to the following: accounting provisions (German Commercial Code, IFRS) will generally be affected for cut-off dates after the 1.1.2018. In the tax accounts, if there actually is dynamisation of pension benefits then the resulting effect would be an increase in provisions.

RA Maha Steinfeld

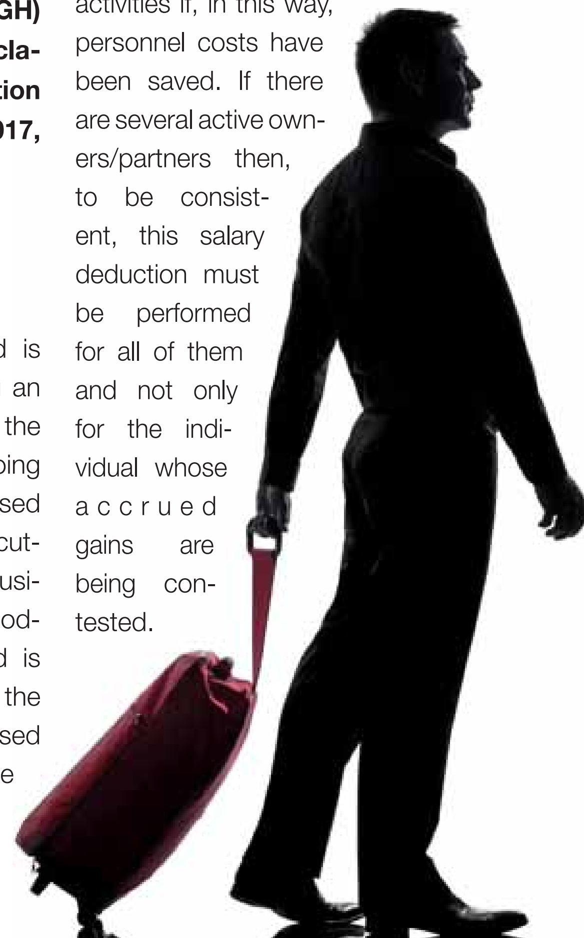
ACCOUNTING & FINANCE

Valuing a business for the compensation of accrued gains

Despite the fact that divorce rates in Germany are still high, frequently, there are no pre/post-nuptial agreements. Consequently, the statutory matrimonial property regime of the community of accrued gains *(Güterstand der Zugewinngemeinschaft)* applies. Accordingly, the assets of the spouses remain separate, however, in the event of a divorce, the difference in the growth in the value of the assets during the marriage has to be compensated. If one of the spouses has engaged in successful business activities then the claim for compensation could be considerable and this could also lead to a liquidity problem. Therefore, the controversial issue of how a business, or a stake in the business should be valued when determining the amount for the compensation of accrued gains will be of particular importance. The Federal Court of Justice (*Bundesgerichtshof*, BGH) recently had the opportunity to clarify a number of basic valuation parameters (ruling from 8.11.2017, case reference: XII ZR 108/16).

1. Valuation method: (modified) income capitalisation method

The income capitalisation method is usually appropriate for determining an objective fair value. In this case, the expected future earnings of the going concern are determined, capitalised and are based on the valuation cut-off date. For owner-managed businesses or freelance practices a modified income capitalisation method is applied. This takes into account the extent to which earnings are based on the owner's particular knowledge and skills and, therefore, whether or not the earnings power of the business is only partially transferable or just for a limited time. Furthermore, a business owner's salary should be deducted from the estimated earnings. This should cover not only the management of the business but also the owner's other 'non-managerial' activities if, in this way, personnel costs have been saved. If there are several active owners/partners then, to be consistent, this salary deduction must be performed for all of them and not only for the individual whose accrued gains are being contested.



2. Cut-off date principle

The applicable date for the valuation will be the date of the filing of the divorce petition. If the business already existed prior to marriage then it is this date that should also be used when determining the starting value of the assets. This should be based here solely on the knowledge that could possibly have been available on the respective cut-off date. Even if, on the date of the valuation, the subsequent actual (earnings) development is known it may only be generally taken into account insofar as, based on the conditions on the cut-off date, it was sufficiently specifically foreseeable. As part of the accrued gains calculation, the value of the business that is determined on the basis of the starting value of the assets should be projected in accordance with the consumer price index in order to compensate for the accrued gains that have arisen merely through inflation.

3. Taking into account deferred tax charges

The BGH confirmed once again that the value of the business should be reduced by the amount of taxes on earnings that would be incurred in the event of a sale of the business. This will apply irrespectively of whether or not a sale is planned. Given that the valuation method targets a fictitious sale price then likewise, when seeking to compensate the accrued gains, only the net proceeds that would economically remain available to the vendor can be taken into consideration. Therefore, the tax charge that would have been incurred in the event of a sale of the business at the calculated value would have to be determined and deducted accordingly. The fictitious tax charge from the sale on the cut-off date is applicable. If the business owner was, for example, not yet over 55 years of age on this date then the age-related concessions (reduced tax rate) should likewise not be taken into consideration.

4. No inheritance and gift tax

Recipients of compensation for accrued gains do not incur an inheritance or gift tax liability on this amount. The same applies if the matrimonial property regime is terminated through the death of one of the spouses. Any fictitious amount of accrued gains that the surviving spouse could have claimed effectively acts as an additional tax-free allowance in addition to the personal tax-free allowance of € 500k.

5. Recommendations

In intact marriages, the tax exemption for accrued gains provides a degree of structuring potential for transferring assets between spouses. Thus, early compensation by switching to a nuptial agreement on the separation of property could be considered. Once the tax-exempt accrued gains are paid then it is possible to switch back into the statutory matrimonial property regime (so-called property regime seesaw). In this way, even gifts that have already been made could be retroactively transformed into tax-exempt compensation for accrued gains. Please do not hesitate to contact us for details of how this can be realised.

RA Frank Moormann

AND FINALLY...

"I think it's smart for the United States to have some kind of tax revenue for international earnings - if that tax were reasonable".

Tim Cook, CEO Apple, born 1.11.1960.

Impressum

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