PKF

Accountants &
business advisers

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Editorial

Dear Readers,

Legislators in Germany have set up greater obstacles for **deducting dividends, for trade tax purposes**, from non-EU states than from Germany. In this respect, in the Focus section we report on an ECJ ruling that deems that this practice violates the principle of the free movement of capital. The excessive requirements as regards the holding period and the activities of the subsidiary companies as well as the lower-tier subsidiaries in third countries were denounced.

In the Tax section, the focus is on the **use of losses** in the private sphere. If a loss has already been suffered then it should at least be possible to offset it for tax purposes because, moreover, the tax authorities are ultimately not circumspect when it comes to profits. Following on from this, there is an article about when a **permanent establishment** could already be deemed to exist - the tax authorities have shown themselves to be increasingly creative here in recent times and, unfortunately, this has also frequently met with the approval of the courts. By contrast, there are also court decisions that stand out for positive reasons when it comes to the **tax privileges for cumulative payments** when an employment contract is terminated, or when those who were invited to a company party do not turn up and others (are supposed to) deal with the consequences. Finally, we highlight a **reporting requirement** for large companies that has had to be complied with since the start of the year.

The 'Legal' section is all about the setting of limits. First of all, this concerns **cases involving director's liability** that are not covered by an insurance policy. Subsequently, we report that judges who wish to interpret **marital agreements** too far beyond the written word have been blocked.

In the 'Accounting & Finance' section, to begin with, we have reviewed a case where a taxpayer wanted to use the momentum of the **unconstitutionality of real estate tax** for his own purposes. Finally, you can then read something encouraging about the **valuation of highly indebted companies** – the Institute of Public Auditors in Germany has introduced more flexibility with respect to the choice and the form of valuation method.

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

Your PKF Team

Contents

FOCUS

Deduction of dividends for trade tax purposes – Section 9 no. 7 of the Trade Tax Act is a violation of EU law in cases that involve third countries

Germany imposes stricter requirements in respect of the deduction of third country dividends for trade tax purposes than it does in respect of the deduction of domestic (German) dividends for trade tax purposes. According to a recent ECJ ruling this is a violation of EU law because this unequal treatment constitutes an unjustifiable restriction on the free movement of capital.

1. Background

Generally, dividends between corporations are effectively 95% tax-exempt in order to prevent cascade effects. The pre-conditions are however, not least, a specific minimum size of shareholding (the so-called affiliation privilege) as well as the date when the shareholding was acquired and/or its holding period. Yet, these preconditions are quite different depending on the origin of the distribution. Dividends from

- ... Germany: shareholding at least 15% at the start of the reporting period;
- ... foreign countries in the EU: shareholding at least 10% at the start of the reporting period;
- ... a third country: shareholding of at least 15% continuously held since the start of the reporting period.

Moreover, in the case of dividends from a third country, the entity making the distribution has to have generated its gross revenues exclusively, or almost exclusively, from so-called 'active' operations within the meaning of Section 8(1) no. 1 to 6 of the Foreign Transaction Tax Act (*Außensteuergesetz*, AStG). Besides, in order to benefit from the so-called lower-tier subsidiary tax privilege - this applies to dividends from foreign downstream companies - the third country entity also has to act as a functional holding company or as a country holding company.

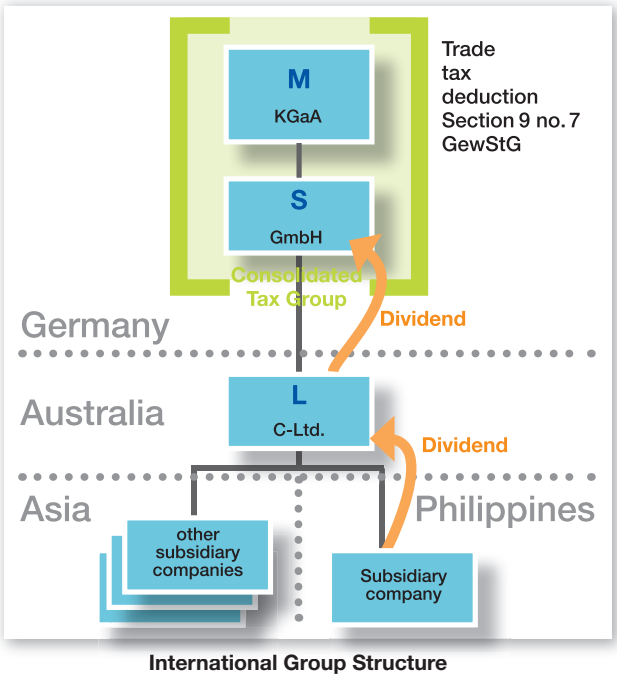
» **Please note:** In addition, the taxpayer has to provide proof that the above-mentioned conditions have been met by submitting the relevant documentation.

2. The issue referred by the Münster tax court to the ECJ

A Germany-based parent company (P) of a global concern, in the legal form of a German partnership limited by shares (KGaA), had brought a legal action. P held all the shares in a Germany-based limited company (GmbH) with which it was associated within a consolidated tax group for income tax purposes. The subsidiary company (S) in turn held 100% of the shares in an Australian C-Ltd. This lower-tier subsidiary (L) was a holding company for Asia and Australia that held further shareholdings in this region and received dividend income. In 2009, C-Ltd. distributed dividends to the German GmbH that had originally come from a profit distribution of a Philippine subsidiary as well as from its own retained profits brought forward, which had been built up over several years.

M treated the profit distributions from C-Ltd. that it had received via its subsidiary company as effectively 95% tax-exempt in accordance with Section 8b(1),(5) of the German Corporation Tax Act (*Körperschaftsteuergesetz*, KStG). In the course of a subsequent tax inspection, the 95% tax exemption for the profit distribution was refused in respect of trade tax. This was on the grounds that the pre-conditions relating to operations, in accordance with Section 9 no.7 clause 1 of the Trade Tax Act (*Gewerbesteuergesetz*, GewStG), had not been met because C-Ltd. did not satisfy the requirements for an (actively operating) functional holding company or country holding company.

Following an unsuccessful appeal against this decision, M brought an action before the Münster tax court. This court was not sure that Section 9 no.7 GewStG conformed to EU law



International Group Structure

and so it referred the case to the ECJ for a preliminary ruling (order for reference from 20.9.2016, case reference: 9 K 3911/13 F).

3. The ECJ ruling from 20.9.2018

First of all, the ECJ explained that the tax treatment of dividends may generally fall within the scope of application of both Article 49 of TFEU (freedom of establishment) as well as Article 63 of TFEU (free movement of capital).

However, there has to be an examination of Section 9 no.7 GewStG with respect to the free movement of capital as the required minimum shareholding of 15% of the nominal capital of the subsidiary company does not necessarily mean that the company that holds this is able to exercise definite influence on the decisions of the company that distributes the dividends. In this respect, this is crucial otherwise the freedom of establishment would have been relevant, although this has no effect vis-à-vis third countries.

As expected, the ECJ subsequently established that there was a restriction on the free movement of capital because, with respect to distributions of dividends by subsidiary companies based in third countries, Section 9 no.7 GewStG provides more stringent requirements than Section 9 no.2a GewStG with respect to distributions by domestic (German) companies.

In the opinion of the ECJ, the standstill clause in Article 64(1) TFEU that has to be taken into account in this respect - according to which restrictive provisions for structures with third countries related to direct investments are exceptionally allowed if they had already existed on 31.12.1993 - is not applicable.

- This is because, firstly, the provision in Section 9 no.7 GewStG was amended in 2007 (the minimum shareholding threshold was raised from 10% to 15%).
- Secondly, the extent of the deduction was also changed (instead of the gross dividend it is now the net dividend) and taxation of dividends underwent a fundamental change of system through the transition from the tax credit procedure to the half-income method.

Ultimately, the ECJ was of the opinion that the restrictions based on Section 9 no.7 GewStG could not be justified by the need to prevent abuses and tax evasion either.

- On the one hand, there is no identifiable abuse that the provision is supposed to combat and,
- on the other hand, there is no opportunity for the taxpayer to refute allegations of abuse.

4. Consequences for practice

This ruling is of far reaching significance for German entities with subsidiary companies in third countries. This is because the interpretation of Section 9 no.7 GewStG that is now required in order to comply with EU law means that the same pre-conditions will apply for the deduction of dividends from third countries for trade tax purposes as for domestic (German) dividends (Section 9 no.2a GewStG).

As a result, neither the requirement concerning operations for third country dividends nor the extensive obligations to provide supporting documents under Section 9 no.7 GewStG would be permissible. Repatriating third country profits would thus be considerably simplified.

» **Recommendation:** For the time being, it remains to be seen how the German tax authorities and the legislator will respond in the future to the judgement from 20.9.2018 (case: C-685/16, EV/Finanzamt Lippstadt). However, due to the far-reaching consequences of the provision it is hardly likely that we will have to wait a long time for a response - we will keep you informed.

StB [Tax consultant] *Dr. Dominic Paschke*

TAX

Optimal use of loss compensation pools for investment income

In the PKF Newsletter 5/2018 we discussed the options and limits for loss relief in the case of income from capital assets. To this end, credit institutions keep separate compensation pools in each case for losses that arise from the sale of shares as well as from other sources. If there are loss compensation pools at various credit institutions then it is possible to compensate losses across all accounts and/or securities accounts not only within the scope of a tax return but, potentially, also across all the banks. The application for the loss statement that is required for this should be made, at the very latest, by 15.12. of each year. In the following section we give an overview of the loss compensation options.

1. Alternatives for compensating losses within the space of one year

If, in the course of a calendar year, initially losses are realised and sub-

sequently positive capital gains are realised then the losses allocated to the compensation pool can be offset against the positive capital gains. Conversely, if positive capital gains are initially generated and tax is deducted by the bank then it is obliged to offset the capital gains that have already been taxed over the course of the year with subsequent losses and to refund the excess withholding tax that was paid.

» **Please note:** You should bear in mind that a declaration for exemption from withholding tax that has already been taken into account would enter into force again if, initially, positive capital gains had been taxed and, over the course of the year, these had been subsequently offset against losses. In such a case, the declaration for exemption from withholding tax would take effect in the amount of the losses that had been compensated and could be applied again.

2. Collective loss compensation for spouses

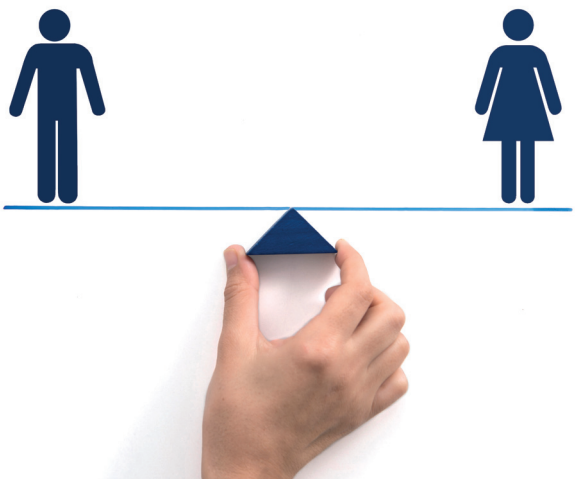
Spouses are generally able to offset their losses collectively, i.e. across all the accounts and securities accounts that they both keep at a bank. Here, it makes no difference whether or not these are individual accounts/securities accounts or joint accounts/securities accounts. In order for losses to be compensated collectively for spouses it necessary to have a joint declaration for exemption from withholding tax for the spouses. If the spouses initially issued individual declarations for exemption from withholding tax then issuing a joint declaration can result in a retroactive refund of the capital gains tax already paid in the current year. The same applies for the year in which the marriage takes place. However, if neither an individual nor a joint declaration for exemption from withholding tax has been issued then, within the scope of a tax return, the losses can be compensated collectively by means of a loss statement and with due regard to the restrictions in respect of loss compensation.

3. Compensation of losses across credit institutions

The system of deducting withholding tax at the source does not generally provide for the automatic compensation of losses and gains from capital assets across credit institutions but, instead, the losses have to be credited in the course of an assessment procedure (see below). However, there is an exception in the case of a complete transfer of a securities account. Here, upon request, a taxpayer can transfer existing losses at the same time. In order to be able to determine accurately the gain or loss that is generated in the event of a sale, the transferring credit institution provides the acquiring credit institution with the appropriate acquisition data.

» **Please note:** If the customer relationship with a credit institution is broken off then the appropriate request should made if you wish to transfer a securities deposit account. Otherwise a loss statement will be issued automatically so that loss compensation would only be possible within the scope of a tax return (please see below).

Losses can be balanced out, in particular, between spouses



4. Compensating losses within the scope of a tax assessment

If at the level of the credit institution it is not possible to compensate losses among the accounts or security accounts that are kept there and if a loss statement has been issued then the taxpayer can apply to offset losses of any other kind with positive income from capital assets while applying his/her personal tax rate (an assessment on the basis of the most favourable provision for the taxpayer); s/he then has to declare all investment income. Alternatively, the taxpayer can also apply for a tax assessment on the basis of the withholding tax rate (application for tax assessment). The specific withholding tax rate of 25% then remains in force plus the solidarity surcharge and church tax. The application can be limited to a part of the investment income; in that case, only the accounts or securities accounts at the same credit institution are included. It is also worth making an application if there is an existing loss carry-forward from capital assets at the assessment level (Section20(6) of the German Income Tax Act (*Einkommenssteuergesetz*, EStG).

5. Structuring - business reclassification of investment income for the purpose of utilising losses

In order to avoid the various restrictions in respect of loss compensation in the case of income from capital assets, potentially, it may be appropriate, for example, to take shares out of private assets and contribute them (designated as being for business purposes) to operating assets. According to the wording of the law, the contribution should be recognised at its net present value (value reported on an appointed date) however, at the cost

of acquisition at most. In the case of shareholdings of at least 1% or loan receivables equivalent to these, by way of derogation, these always have to be recorded at the cost of acquisition with no option for a writedown in accordance with the decision made a long time ago by the Federal Fiscal Court (*Bundesfinanzhof*, BFH) in its ruling from 2.9.2008 (case reference: X R 48/02 – accepted by the tax authorities in the form of H 17(8) of the Income Tax Guidelines (*Einkommensteuerrichtlinien*, EStR) - and recently also reaffirmed (ruling from 29.11.2017, case reference: X R 8/16). However, losses that have arisen in the private sphere would only be taken into account once the shareholdings have been sold.

» **Recommendation:** The analogous application of the above-mentioned ruling for shareholdings below the 1% threshold has not yet been definitively clarified. Nevertheless, in order to utilise wthe corresponding loss potential you should consider declaring a contribution at the cost of acquisition while disclosing this course of action accordingly.

Irrespective of the size of the shareholding, there is a risk that executing the sale of shares of diminished value immediately after they have been contributed would not be accepted by the tax authority for tax purposes. Furthermore, under the partial income method, only 60% of the losses from the disposal of assets are deductible. By the same token, instead of the above-mentioned restrictions for private assets, offsetting losses against business income and/or potentially also income of any other kind could possibly be achieved.

WP / StB [German public auditor and tax consultant] *Dr. Dietrich Jacobs/ Tim Sporkmann*

Income tax – The limits of the abuse of tax structuring options and the purpose of loss statements

» **Who for:** Taxpayers who sell units or shares.

» **Issue:** In 2009 and 2010, the claimant had purchased shares with an overall value of € 6,000 through his *Sparkasse* (savings bank). In 2013, he sold them back to the *Sparkasse* in two instalments at a sale price of € 6 and € 8. The *Sparkasse* charged the claimant transaction fees in the amount of the respective sale prices so that the blocks of shares were ultimately transferred in each case for € 0. In view of the provisions of the tax authorities (the Federal Ministry of Finance (*Bundesministerium der Finanzen*, BMF) circular from 9.10.2012, which has now been replaced with the BMF circular from 18.1.2016, case reference: IV C 1-S 2252/08/10004, subsection 59), according to which a sale shall not be assumed if the sale price does not exceed the transaction costs, the *Sparkasse* did not register the losses in the so-called loss compensation pools and, accordingly, no statement was issued as defined in Section 43a(3) clause 4 of the German Income Tax Act (*Einkommenssteuergesetz*, EStG). Nevertheless, in his tax return for 2013, the claimant declared capital losses in the amount of the original purchase costs and he sought to offset these against gains from other share sales. The local tax office did not take the losses into account because the loss statement was missing. The claimant's appeal was rejected by the local tax office in view of the administrative opinion as laid down in the BMF circular. Moreover, in the appeal, the local tax office argued that the structure at issue could be viewed as an abuse of tax structuring options within the meaning of Section 42 of the Fiscal Code (*Abgabenordnung*, AO) that would enable the taxpayer to benefit from loss compensation; in effect, the parties had agreed a sale price of € 0.

However, the Federal Fiscal Court (*Bundesfinanzhof*, BFH) is of the view of that every transfer of legal or beneficial ownership to a third party results in a sale within the meaning of Section 20(2) clause 1 no. 1 EStG, even if units of no value are disposed of for no consideration or for only a symbolic purchase price. The amount of consideration or the transaction costs incurred in connection with the sale are not important in this respect. Moreover, in the opinion of the BFH, such sales cannot be viewed as being an abuse of tax structuring options within the meaning of Section 42 AO. This would require the taxpayer selecting a legal structure that is not provided for as such under the law. By contrast, the sale of shares is an action that is expressly provided for in order to achieve the desired outcome - in this case, the transfer of shares with no value - irrespective of the economic outcome that is generated as a result. In such a case, the taxpayer merely makes use of the options that have been granted to him/her under the law. The aim of saving tax, on its own, does not mean that such a structuring option should be classified as being inappropriate. It is within a taxpayer's discretion when and with whom and at what return he can conclude transactions.

Furthermore, in the specific case, the missing loss statement did not lead to a situation in which it was not possible to credit the losses. According to Section 20(6) clause 6 EStG, the purpose of the loss statement is merely to prevent the losses being taken into account twice. In the case in question, it was evidently possible to rule this out.

» **Please note:** The taxpayer is generally free to decide if and when s/he wishes to realise any gains from his/her shares as well as the amount of these. Using his/her disposition authority does not constitute an abuse of tax structuring options. The BFH ruling from 12.6.2018 (case reference: VIII R 32/16) is available online at www.bundesfinanzhof.de/entscheidungen.

WPin [German public auditor] *Julia Rösger*

Caution is required with respect to permanent establishments in private dwellings

» **Who for:** Businesses and freelancers that operate internationally.

» **Issue:** Foreign companies have restricted tax liability as regards their operations in Germany with respect to domestic (German) income. A company will be deemed to have domestic income, in particular, if it creates a permanent establishment in Germany. A permanent establishment is any fixed place of business or facility that serves the purpose of being used to carry out a company's operations and is under the company's control (the company has authority to dispose of it).

There have been several rulings in the past in respect of the authority to dispose. If a contractor works at a client's premises and is issued with a room and also given the appropriate access authorisation (e.g. an electronic access card) then the criterion of the authority to dispose is fulfilled (cf. the Federal Fiscal Court (*Bundesfinanzhof*, BFH) with its rulings from 14.7.2004 and 4.6.2008). Recently, the concept of serving a purpose was very broadly interpreted by the Munich tax court. An IT consultant from Uruguay had been working for a German company. In this case, the IT consultant did not have the possibility to dispose of a workstation at his client's premises. In the view of the court, the permanent establishment as the place of effective management was the consultant's private dwelling in Germany.

Whether or not this type of permanent establishment (i.e. the place of effective management) is deemed to exist would be determined on the basis of the business activities in each specific case. If, as in the case of the freelance IT consultant, management activities are necessary from time to time then a private dwelling can also be allocated as the place of management. When there is little need for management activities, such as, e.g., making phone calls or issuing invoices then there is no requirement for a minimum level of office equipment. If such activities are carried out in the dwelling then it could be deemed to be a permanent establishment.

» **Recommendation:** The case described above from the Munich tax court was certainly exceptional because, in addition, under the national law of Uruguay the German income was not taxed and without a permanent establishment in Germany it would have been deemed to be so-called "white income" (i.e. income taxed in no jurisdiction). However, it can be observed that the criteria for what constitutes a permanent establishment - also abroad - are being expanded. This is true for both the definition under national law as well as under DTA law. In cases of uncertainty it would thus be advisable to take measures in advance in the countries concerned so that a permanent establishment is not created.

» **More Information:** A renewed application for leave to appeal against the ruling of the Munich tax court from 31.5.2017 (case reference: 9 K 3041/15) has been lodged with the BFH (case reference: I B 62/17).

StBin [German tax consultant] *Julia Hörning*

Does a reduced rate of taxation for compensation payments presuppose a state of exigency?

» **Who for:** Recipients of compensation payments and severance payments (for short: compensation)

» **Issue:** If compensation is paid it is of great importance to the recipients whether or not they will be able to claim a reduced rate of taxation on the basis of the so-called "one fifth rule" (a form of top slicing relief) (Section 34(2) no. 2 of the German Income Tax Act (*Einkommenssteuergesetz*, EStG) in connection with Section 24 no. 1a EStG). In the past, in the opinion of the tax authorities and according to case law, the prerequisites for Section 24 no. 1a EStG could only be fulfilled if the taxpayer had terminated the employment contract him/herself under considerable legal, economic or real pressure, or if s/he had not contributed to the termination of the employment contract and a compensation payment had been subsequently made (state of exigency). In the case in question, the Federal Fiscal Court (*Bundesfinanzhof*, BFH) has now abandoned this restrictive interpretation.

In its ruling from 13.3.2018, the BFH made it clear that in order for a compensation payment to be classified as being tax-privileged it was sufficient if in the course of the termination of an employment contract by mutual agreement a financial settlement was paid and there was a not insignificant interest on the part of the employer to terminate the employment contract. In the opinion of the BFH, it was not necessary to conduct a further check to determine whether or not the criterion of a state of exigency had been fulfilled.

In its ruling from 23.11.2016, the BFH had already expressed its fundamental doubts about the necessity of the criterion of a state of exigency in accordance with Section 24 no. 1a EStG. Yet, in the recent ruling there were also no specific statements issued on the further significance of the state of exigency.

» **Recommendation:** The difficulties involved in classifying financial settlements as compensation payments, in many cases, should thus be a thing of the past. Nevertheless, you should bear in mind that the BFH has not (yet) basically distanced itself from the criterion of a state of exigency. Therefore, uncertainty will remain for cases that differ from the one in question.

» **More Information:** The BFH rulings that have been mentioned, from 13.3.2018 (case reference: IX R 16/17) and from 23.11.2016 (case reference: X R 48/14) are available online at www.bundesfinanzhof.de

WPin/StBin [German public auditor / tax consultant] *Christina Thiel*

Payroll taxation of company parties

A cookery class as a company event

» **Who for:** Businesses that organise company events.

» **Issue:** In its ruling from 27.6.2018, the Cologne tax court's decision was contrary to the applicable Federal Ministry of Finance (*Bundesministerium der Finanzen*, BMF) circular from 14.10.2015 on the taxation of company events. According to that, cancellations by employees in connection with a company party may not be at the expense, from a tax point of view, of those who do actually attend. The ruling was prompted by the legal action of a GmbH (a German limited company) that had organised a cookery class for its employees as a company event. In the course of the cookery class the participants were allowed to consume an unlimited amount of food and drink. There were 27 participants registered of which however two cancelled at short notice. The costs for the event remained the same. In the context of determining the benefits that were subject to payroll tax, the local tax office stipulated that these should be based on the actual 25 employees who participated with the result that the amount that had to be taxed was higher. By contrast, the Cologne tax court calculated the amount that was subject to tax by dividing the overall costs for the event by the original number of employees who had registered (27). The reason that the tax court gave for doing this was that the 'no show costs' that had arisen because two employees had not participated had not resulted in non-cash benefits being generated for those employees who did take part in the event. The option to consume an unlimited amount of food and drink meant that the cancellation by one participant would not have had the effect of augmenting the benefit intended for an individual. The tax court's view thus also differed from the administrative opinion that stipulates that the expenses that were incurred have to be divided by the number of people who took part.

» **Recommendation:** The Cologne tax court has permitted an appeal. It would be advisable to keep comparable cases open by making reference to the Cologne tax court ruling until the decision of the Federal Fiscal Court (*Bundesfinanzhof*, BFH).

» **More Information:** The tax court ruling from 27.6.2018 (case reference: 3 K 870/17) is available at www.fg-koeln.nrw.de (German version only). The appeal is pending at the BFH under the case reference: VI R 31/18).

StB [Tax consultant]
Hans-Rudolf Pollmeier

New reporting obligations – Country-by-country reporting for multinational groups of companies

» **Who for:** Groups of companies that operate internationally.

» **Issue:** Action point 13 of BEPS (Base Erosion and Profit Shifting) contains guidance on transfer pricing documentation and country-by-country reporting. The country-by-country report (CbCR) is a part of the three-tiered standardised approach for documentation. CbCR was adopted into national law in Section 138a of the Fiscal Code (*Abgabenordnung*, AO). The reports have had to be submitted to the Federal Central Tax Office (*Bundeszentralamt für Steuern*, BZSt) since 2016 and, from 2017, a supplementary statement has had to be included in the tax return. According to the Federal Ministry of Finance (*Bundesministerium der Finanzen*, BMF) circular from 11.7.2017 (case reference: IV B 5 - S1300/16/10010) the following should be taken into account here.

(1) Report to the BZSt - Entities with headquarters or management in Germany are obliged to submit a country-by-country report to the Federal Central Tax Office (BZSt) if their consolidated turnover in the preceding financial year was at least € 750 m (primary mechanism). German group companies with a foreign group parent company are only required to prepare and submit a report if they have been instructed to do so by the foreign group parent company, or if the foreign group parent company does not submit a report (secondary mechanism). The following data, in particular, have to be reported for all the business units - broken down by tax jurisdictions - of the multinational group:

- revenues and other income,
- taxes paid and accrued in the financial year,
- annual pre-tax profit,
- equity capital,
- retained earnings,
- number of employees and
- tangible assets.

Moreover, the most important business activities of the individual companies have to be described. The report has to be drawn up in a format specified by the OECD and can be in English.

(2) Temporal application - Country-by-country reports in accordance with the primary mechanism have already had to be submitted for financial years that started after the 31.12.2015. Reports in accordance with the secondary mechanism have to be prepared for financial years that started after the 31.12.2016. For the latter financial years, information has to be provided in the tax return about who will prepare the country-by-country report.

» **Recommendation:** Submitting a country-by-country report that is incomplete or late constitutes a regulatory offence that is subject to a penalty. Groups should therefore check whether or not a reporting requirement exists and which organisational unit should submit the report. In particular, foreign group parent companies should be consulted in order to obtain the requisite information.

StBin [German tax consultant] Sabine Rössler

LEGAL

Directors' liability risks – D&O insurance does not cover payments after factual insolvency

» **Who for:** Shareholders and agents of corporations.

» **Issue:** In the course of business transactions, executive bodies are exposed to various liability risks. In order to protect against these risks companies frequently take out directors and officers insurance cover (abbreviated to D&O insurance). This is liability insurance for financial losses to protect the agents acting for a company from personal claims. However, this does not cover all potential claims, as a managing director discovered in a case that was dealt with by the Düsseldorf court of appeals (*Oberlandesgericht*, OLG). There, an insolvency administrator had successfully sued a managing director for the payment of over € 200,000 because after her company's factual insolvency she had continued to initiate electronic bank transfers (Section 64 of the Limited Liability Companies Act (*GmbH-Gesetz*, GmbHG)). She has now failed, in front of a court, in her attempt to pass the claim on to the D&O.

A claim against managing directors arising from Section 64 GmbHG - according to the OLG in its ruling that established this principle, from 20.7.2018 (case reference: I-4 U 93/16), – is not a statutory liability claim but rather a claim for compensation of a sui generis nature that is intended to protect creditors and not a company. It cannot be compared with a claim for compensation because of a financial loss and that is why it is not included in the coverage of a D&O insurance policy. However, the situation would be different, e.g., in the event of a claim because of a breach of the obligation to file for insolvency. In such a case, this would be a genuine claim for compensation (Section 823(2) of the German Civil Code in connection with Section 15a(1) of the German Insolvency Code) that would also fall under D&O insurance coverage.

» **Recommendation:** Managing directors are frequently not able financially to bear losses in cases of insolvency. Providing D&O insurance cover is thus usually also in the interests of the company or its insolvency administrator. Therefore, careful consideration should be given to the legal basis for claims against managing directors.

RA/StB [German lawyer/tax consultant] Frank Moormann

Marital agreements – the limits to judicial control over their performance

» **Who for:** Spouses with marital agreements.

» **Issue:** The provisions in a marital agreement are subject to a two-stage check. First of all, they are examined with regard to their effectiveness in accordance with Section 138 of the Civil Code (*Bürgerliches Gesetzbuch*, BGB). In a second step, they undergo judicial scrutiny. Subsequently, a spouse may be disallowed from invoking a provision that is beneficial for him/her due to an abuse of legal rights (Section 242 BGB). This would be possible if, at the time when the marriage broke down, the ensuing distribution of burdens between the spouses was obviously one-sided and unreasonable. This should be presumed, in particular, if the mutually agreed organisation of the marital living conditions is fundamentally different from the original life plan on which the agreement was based.

However, tight limits have been placed on the judicial control over the performance of the agreement, as the Federal Court of Justice (*Bundesgerichtshof*, BGH) affirmed in its ruling from 20.6.2018 (case reference: XII ZB

84/17). The equalisation of accrued gains is subject to the widest extent to the disposition laid down in the marital agreement. Therefore only marriage-related disadvantages can be rectified. Marriage-related disadvantages can arise from childcare and an employment history that differs from the original life plan. If there are no such disadvantages, or if these have already been fully compensated for (in particular, through an equalisation of pension rights and accrued gains) then the purpose of the judicial control over the performance is not to grant the spouse who has been disadvantaged by the marital agreement any additional (missed) marriage-related benefits. Moreover, the spouse should not be in a better position as a consequence of this than if the marriage and the dispositions of the type and scope of the respective employment associated with the marital role allocations had not occurred.

How far reaching is the judicial control over the performance of a marital agreement?

» **Recommendation:** Provisions in marital agreements can lead to many disputes although they are supposed to prevent precisely such disputes. In order to prevent a spouse from being unilaterally and unreasonably disadvantaged the provisions in marital agreements should be reviewed on a regular basis and, if necessary, adjusted to take into account the particular current life circumstances of the married couple.

RAin/StBin [German lawyer/tax consultant]
Dany Eidecker

ACCOUNTING & FINANCE

The applicable rent for real estate tax purposes under the income capitalisation method

» **Who for:** Landlords who calculate the value of their building for real estate tax purposes by means of the income capitalisation method.

» **Issue:** In 2007, a claimant bought a piece of real estate with a residential building on it that had been built in 1981. In the following year, the claimant divided up the property into five residential property units and two parcelled units in the form of garages. The local tax office determined rateable values for these units as at 1.1.2009 by way of a subsequent determination of assessed value. In this case, the residential properties were valued as single-family houses using the income capitalisation method based on rent of DM 3.90/sq. m (well-appointed) and a multiplier of 9.1 (post-war building after 20.6.1948). The value of the garages was calculated on the basis of the asset value method.

In practice, the gross annual rental income that is applicable under the income capitalisation method is mostly calculated in accordance with Section 79(2) of the Valuation Act (*Bewertungsgesetz*, BewG). In order to determine the general rent levels, the tax offices normally use rent indices that show the monthly rent broken down by year of construction and features of the fixtures and fittings as at the date of the main assessment on 1.1.1964. In most cases, the fixtures and fittings have been classified as being simple, average, good and very good.

The claimant held the view that the rules for assessing the rateable value as at 1.1.2009 were no longer constitutional. The distortions in the values were such that they were no longer acceptable with the result that the rent as at 1.1.1964 was no longer an appropriate basis for determining general rent levels. Therefore, Section 79(2) BewG had to be interpreted in conformity with the constitution such that the rents to be applied for the assessment of the rateable value should be determined retroactively on the basis of up-to-date rent indices by calculating back to 1.1.1964.

The case before the tax court and the claimant's appeal before the Federal Fiscal Court (*Bundesfinanzhof*, BFH) were unsuccessful.

The case has gained a particular relevance given the current developments in real estate tax. The Federal Constitutional Court (*Bundesverfassungsgericht*, BVerfG) in its ruling from 10.4.2018 decided that, in any case, the tax on real estate which has been developed had not been compatible with Section 3(1) of the Basic Law (*Grundgesetz*, GG) since 1.1.2002. New rules have to be introduced by 31.12.2019 - until then, the rules that have been deemed

to violate the German constitution may continue to be applied. The reason for the decision that the real estate tax in its current form is unconstitutional is that the rateable values have not been adjusted for more than 50 years - this has resulted in severe unequal treatment (see also PKF Newsletter 5/2018).

The reference date for assessing the value of residential property for real estate tax purposes is 1.1.1964

The BFH ruled that calculating back the rents, which form the basis of the assessment of the rateable value, from the current rent indices is not permissible. The method that the claimant was seeking to use was accordingly not compatible with the BewG. The property values on the date of the main assessment on 1.1.1964 invariably remain applicable for the rent levels, even for adjustments and the subsequent determination of assessed value. The multipliers that have to be applied to the gross annual rental income can be found in the appendices to the BewG. These reveal that the multipliers were likewise determined in accordance with the circumstances as at 1.1.1964. Deviating from these is not permitted. The principle of the multiplier is based on net income, which is calculated by taking into account approximated operating expenses and ground rent yields, broken down according to types of real estate, categories for the year of construction and municipality size classifications. Consequently, these multipliers can be applied directly to the gross income. The claimant had criticised that with regard to the assessment of real estate values, the distortions in values over the last 50 years were not reflected here. The different developments, for example in the big cities, where real estate values have appreciated more strongly than in rural areas, are not taken in account in the method that is currently applicable. Calculating back from today's rent indices to the level as at 1.1.1964 would take into account these changes in values.

With the procedure that has to be currently applied, which takes into consideration certain approximated reductions and increases, there is a conscious acceptance of a simplified and standardised procedure. Despite the unconstitutionality of the regulations in respect of real estate tax these will - according to the BFH - still have to be applied up to a certain point in time (initially up to 31.12.2019).

» Recommendation: To summarise, it is not permissible to calculate back the rents from the current rent indices for valuations under the income capitalisation method. Even though real estate tax is calculated on the basis of unconstitutional rateable values as at 1.1.1964, nevertheless, real estate owners have to accept these until there are new rules in place for the assessment of rateable value. In view of the high administrative expense that would be incurred for a revaluation and the serious budgetary problems that would otherwise loom for the municipalities, the continued validity of the legal situation to-date - despite the fact that it violates the principles of equality - is exceptionally justified.

» Please note: The BFH ruling from 16.5.2018 (case reference: II R 37/14) is available at www.bundesfinanzhof.de/entscheidungen.

WPin [German public auditor]
Julia Rösger

The particularities of the valuation of highly indebted companies

The Institute of Public Auditors in Germany (Institut der Wirtschaftsprüfer, IDW) published its Practice Statement (Praxishinweis) 2/2018 on 'Taking Account of the Gearing Ratio when Valuing Businesses' in October 2018. This Practice Statement specifies, above all, the particularities that could emerge when valuing a highly indebted business. Furthermore, it provides guidance on how it is possible to deal with these particularities in order to determine an objectified value for a business.

1. Planning future financial surpluses

The value of a business is generally determined on the basis of the present value of future net inflows to the business owners (net income as the balance of profit distributions and/or withdrawals, capital repayments and contributions). The basis for the forecast of future financial surpluses is the earnings power of the business that exists on the valuation cut-off date. With regard to the planning of future financial surpluses, in the case of highly indebted companies there should be an analysis as to whether or

not, when compared with the sector, significantly higher gearing can be assumed for the long term. In connection with the elevated default risks of highly indebted companies it is important to critically question whether the default risks have already been taken into account in the financial projection and how this has been done. If default probabilities are taken into account in the financial projection then they should be unbiased in the sense of being the best possible estimate.

2. Net method versus gross method

When a net method is used, if the entity being valued has a considerably higher gearing ratio than businesses that have a normal level of indebtedness then the resulting level of the values that are assumed for indebted cost of equity, which are based on capital market theory models, cannot generally be explained either in relation to their content or empirically. Such values can be an indicator that the operational business risks, the capital structure risks and the default risks have not been properly taken into consideration and that the respective return on investment requirements of the various groups of capital providers have not been incorporated in a way that makes them consistent with each other.

For this reason and in order to increase transparency when valuing highly indebted companies, the recommendation is to perform the valuation based on a gross method. With gross methods, irrespective of the high level of debt, as a first step, the present value of the operating financial surpluses - including the value contribution of the tax benefit arising from the indebtedness - are calculated (e.g. in accordance with the WACC approach or by means of the adjusted present value method) and from this, in a further step, the market value of the debt capital is then deducted. In this way, it is thus possible to take account of operational business risks, capital structure risks and default risks separately and, therefore, transparently.

Nevertheless, even with a gross valuation the question remains of how to properly determine the expectation value of the operating financial surpluses as well as the appropriate capital costs. In practice, it can be observed that the entities being valued that have considerably higher gearing ratios when compared with their peer group, all things being equal, end up with worse credit ratings and higher debt capital costs. As the gearing ratio increases, besides the share of the operational business risk that has to be borne by the providers of debt capital, in addition, a risk arises that there is only a certain probability that the company will be able to fulfil its contractual performance obligations and will fully service the debt capital (default risk for the providers of debt capital).

3. Default risks

Default risks will have usually already been taken into account in the debt capital yields that can be observed in the market. As default risks affect providers of both equity capital as well as debt capital, the debt capital yields that can be observed in the market are implicit yields for equity capital and empirically established beta factors should be examined with respect to the default risks that are already contained in them. For reasons of consistency, it is necessary to be mindful that default risks, which in each case correspond to the expected debt capital yields and the expected equity capital costs, have to be taken into account or eliminated depending on the approach that is selected for taking default risks into consideration in the valuation calculation. In this connection, forecasts of financial surpluses should be scrutinised to see if the default risks have already been incorporated. If this is the case then they should not be included in the capital costs. Otherwise, the default risks will have to be taken into account in the equity and debt capital costs.

4. Capital costs and the appropriate peer group

When determining an objectified value for a highly indebted company it is appropriate to derive the interest rate that will be used to discount the operating financial surpluses on the basis of the capital costs of companies that have comparable operations (peer group) but normal levels of debt. This is necessary in order to take account of the operational business risk adequately and transparently. In order to derive the expected return of the debt capital the appropriate default risk from the debt capital yields that can be observed in the market for the entity to be valued then has to be eliminated. However, if it is not possible to derive the expected return of the providers of debt capital, which is relevant to the valuation, in a nonarbitrary manner then the IDW recommends basing the return on the debt capital costs of the peer group of businesses with normal levels of debt. Consequently, with this method, equity and debt capital costs and thus the weighted cost of capital approach (WACC) do not reflect default risks but instead merely the operational business risks. The default risks associated with highly indebted companies would then have to be taken into account and made transparent in the forecasts for operating financial surpluses. Against this background it is important to critically question whether or not the default risks have been adequately taken into account in the forecasts for the future financial surpluses and to what extent. The market value of the equity capital is then arrived at by deducting the market value of the debt capital, which includes the default risks, from the figure determined in this way.

WP/StB [German public auditor and tax consultant] Benjamin Sauerhammer

Employment law – No compensation for late salary payment

If an employer delays the payment of remuneration then employees are not entitled to a compensation payment consolidated into a lump sum in accordance with Section 288(5) of the Civil Code (*Bürgerliches Gesetzbuch*, BGB). In the case in question, a long-standing employee sued his employer for the payment of a backlog of benefit allowances owed for five months in 2016. Furthermore, the employee demanded the lump-sum payments in accordance with Section 288(5) BGB in the amount of € 40 for those months when the employer had been in arrears with his payments.

However, the employer argued that these lump-sum payments were not applicable against the background of the specific provisions in Section 12a(1) of the Labour Courts Act (*Arbeitsgerichtsgesetz*, ArbGG) (the parties have no entitlement to the reimbursement of costs at the first instance before the labour courts). The lower courts had still upheld the employee's complaint.

The Federal Labour Court (*Bundesarbeitsgericht*, BAG) now clarified, on 25.9.2018 (case reference: 8 AZR 26/18), that the claimant was not entitled to the lump-sum payments. Section 288(5) BGB does indeed generally apply in cases where the employer is in arrears with its remuneration payments. However, the specific statutory provision in Section 12a(1) clause 1 ArbGG excludes the entitlement to the reimbursement of costs not only with respect to the expenses related to legal actions but also in respect of other substantive and procedural cost reimbursement claims and with which the lump-sum payments in accordance with Section 288(5) BGB are also excluded.

AND FINALLY...

"The question is not whether we have enough qualified people for this. The question is whether or not they enjoy sufficient credibility."

Dr. Berthold Leibinger, shareholder, long-standing chief executive and member of the supervisory board of the TRUMPF Group, 26.11.1930 – 16.10.2018

€ 44-tax exemption limit in the case of benefits in kind – caution is required with respect to dispatching costs

The value of benefits in kind is measured in accordance with the most favourable retail price that is actually paid by end consumers for identical / similar types of goods in the course of general business transactions. The Federal Fiscal Court (*Bundesfinanzhof*, BFH), in its ruling from 6.6.2018 (case reference: VI R 32/18), decided that delivering goods to an employee's home constitutes a service performed by the employer that should be included in the calculation of the tax-exempt amount. If the most favourable retail price in the market is available via mail order or online then this shall also apply to the delivery costs, which are shown as a separate service in online / mail order retail and invoiced accordingly. Therefore, these dispatch or delivery costs have to be included in order to determine if the € 44-tax exemption limit has been exceeded.

Impressum

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