PKF
Accountants & business advisers

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Editorial

Dear Readers,

A documented tax control system not only reduces the risk of violating tax rules but it can also protect a company from damaging its image and the legal representatives from personal liability. PKF has developed a method that in particular meets the needs of medium-sized enterprises. This starts with an analysis of the tax compliance and then systematically identifies and assesses tax risks. Here, the **"PKF Tax CMS Tool"** provides support - it is based on Excel and can be used outside of an ERP system. In the Focus section of this issue we begin our series on **Tax Compliance Management Systems** with two contributions. First of all, we discuss not only the risks that can be managed through such systems but, likewise, the opportunities that can emerge from focusing intensively on processes and interfaces. Subsequently, we provide an overview of the **Four Phase Model** that has been developed by PKF and the PKF tool that can be used in the process.

Tax topics also dominate the sections that follow in this issue. It's bad enough when **equity investments or loans from private assets** to corporations suffer a loss in their value. In the first contribution in our 'Tax' section, we provide an overview of how these **losses** can at least be partially used. The appetites of foreign tax authorities are becoming noticeably bigger and, in the course of this, the end of the value chain is increasingly being identified as an object of taxation – in the second article you can read how **digital permanent establishments** will become an object of taxation. Subsequently, we discuss what can be expected as a result of the ruling on the **unconstitutionality** of the antiquated values that are used as the basis for **real estate tax**. Our final article is about the awareness by the tax authorities that in one or other cases they may well have gone too far - this can frequently be recognised by the letters added to section numbers.

Finally, in the Accounting & Finance section we point out a problem in connection with disclosure obligations.

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

Your PKF Team

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FOCUS

Tax Compliance Management Systems – Part A: Take advantage of opportunities and avoid risks with the aid of the Four Phase Model

Whether it be price-fixing agreements, slush funds, unreasonable working conditions, discriminatory marketing campaigns, data and bribery scandals, or tax avoidance and tax evasion, such compliance violations in all recent cases have resulted in high costs, damage to a company's image and personal liability for the parties involved. In our new series on Tax Compliance Management Systems (Tax CMS), in this and in subsequent issues of our PKF Newsletter, we will be discussing how, in the area of tax, you can avoid risks, enhance the quality and efficiency of processes and, ultimately, save resources. PKF's so-called Four Phase Model plays a key role here (cf. Fig. 1) and our presentation of this model follows after a general overview.

1. Reason for, concept behind and aims of a Tax CMS

1.1 Conceptual and legal frameworks

In its administrative guidance on Section 153 of the (German) Fiscal Code, from 23.5.2016, the Federal Ministry of Finance (Bundesministerium der Finanzen, BMF) included a passage stating that an internal control system could be an argument against the existence of wilful intent or recklessness. Although no direct requirement can be derived from this text passage, the administrative guidance does recommend that the issue of implementing a Tax CMS should be intensively addressed - in particular by medium-sized enterprises, too.

The concept of a Tax CMS consists of the components of compliance and a management system and primarily relates to the tax area. Compliance means observing rules. A management system is understood to mean, among other things, the procedures and measures adopted by an enterprise for ensuring the effectiveness and profitability of its business activities, avoiding financial losses and complying with the relevant legal requirements.

A CMS includes all reasonable measures for an enterprise that ensure that it acts in a compliant manner and prevent violations by the legal representatives and employees.

1.2 Avoiding risks and taking advantage of opportunities

An existing and effective Tax CMS reduces risks when dealing with tax obligations and it should make it more difficult in the future for the tax authorities to justify a criminal accusation. A distinction can be made between three main risk categories:

- There are risks under liability law for company representatives if they breach their duty to supervise tax claims but also for individual employees who could be accused of tax evasion.
- There is also a risk of monetary fines for business owners with respect to potential Organisationsverschulden (liability of management for torts of employees based on the failure to establish and maintain proper organisational structures) (pursuant to Sections 30 and 130 of the German Administrative Offences Act). For example, if an advance VAT return is incorrect then questions will be asked as to whether or not the organisational structure is adequate and reasonable supervisory measures have been adopted in order to prevent such a mistake from happening.
- The risks under criminal law consist in the possibility of filing an incomplete or incorrect tax return and thus fulfilling the elements of tax evasion. This could also include acquiescence on the basis of inadequate supervision of the employees.

Defending against accusations under criminal and liability law and safeguarding the enterprise against reputational damage are of great importance. Then again, opportunities can also arise for the enterprise from the implementation of a Tax CMS:

- Clarity about existing processes
- New insights into structures and the exploitation of synergies
- Cost savings through fewer organisational inefficiencies
- Adaptation and realignment of current structures in accordance with future developments

1.3. Growing importance

In the future, it will thus be less about "whether or not" a Tax CMS should be implemented but rather a question of the extent to which it is necessary. The reasons for this are:

(1) an i**ncreasing risk of error** when

Fig. 1 The Four Phases of the PKF Tax Compliance Management System

fulfilling tax obligations due to, among other things,

- complex regulations on taxation in the international context and
- an increase in digital business processes as well as e-invoicing;

(2) an ever-greater **risk of errors being detected**, due to, among other things,

- special tax audits as well as
- the expert knowledge and IT capabilities that are being developed by the tax authorities.

2. An overview of the Four Phase Model

2.1 Approach

PKF has developed a method that in particular meets the needs of medium-sized enterprises. Accordingly, starting with an analysis of the tax compliance status, tax risks are systematically identified and assessed. Subsequently, it is then possible to order the standard module, or other special modules individually. The "PKF Tax CMS Tool" provides support - this is based on Excel and can be used outside of an ERP system. The following four process phases (cf. Fig. 1), which are outlined in the overview below, are guided and documented via the "PKF Tax CMS Tool".

2.2 Phases of the PKF Model

(1) Phase I: Compliance Analysis

First of all, a company's tax compliance status has to be ascertained on the basis of questions that can determine its nature and which relate to seven compliance pillars.

- **Compliance Culture** - Which corporate values are important?
- **Compliance Objectives** - The achievement of which objectives should be ensured?
- **Compliance Organisation** - How has the structure and the workflow of compliance been set up?
- **Compliance Risks** - How is risk management organised?
- **Compliance Programme** - What measures are used to manage compliance risks?
- **Compliance Communication** - What guidelines or reporting systems are in place?
- **Compliance Monitoring/Improvements** - What ongoing measures are planned for monitoring and improvements?

The analysis is performed on the basis of interviews and checklists. The PKF Tax CMS Tool can be used to produce the documentation in the form of a short report. For standard modules (cf. Phase II) an assessment of the risk situation is then made within the scope of detailed tax compliance analyses.

(2) Phase II: Risk analysis

On the basis of the results of the compliance analysis performed in Phase I, a selection is made from among the standard modules - tax on earnings, VAT, transfer pricing, payroll tax/social security as well as documentation relating to procedures and processes in accordance with the (German) Principles of Proper Keeping and Retention of Accounts, Records and Documents in Electronic Form as well as Access to Data for social security - of those modules that should (initially) be examined in detail. The following steps are dealt with via the PKF Tax CMS Tool in a dialogue between the client and the consultant:

- identification of the risks related to these processes
- identification of the existing rules and controls for these processes
- assessment of the risks relating to the extent of loss and occurrence probability
- reporting on the risk situation
- definition of the action required to reduce the risks

Risk indicators (the product of the extent of loss and occurrence probability) are created on this basis for the respective modules and these indicators can be graphically represented via the software.

Compliance - The process of complying with external and internal standards provides opportunities, too.

(3) Phase II: Measures for guidance and monitoring

In this phase, risks with high or very high indicator values - the so-called "red zone" - are

prioritised. The following measures and controls are examples of what could be defined in this phase and then implemented with the aid of the PKF Tax CMS Tool:

- preparation of a tax handbook
- organisational guidelines, procedural instructions, checklists (manual or electronic)
- review of the appropriateness of transfer prices
- preparation of transfer price documentation
- description of controls (manual or electronic)
- definition of communication policy in the event of deviations from guidelines

The aim here is to move the risks out of the "red zone" into the yellow (medium risk) or green (low risk) zones.

(4) Phase IV: Effectiveness and review

This phase follows, somewhat later, phases I to III. It involves so-called functional tests, i.e. whether or not the measures and controls set up in Phase III are also actually being put into practice.

» **More Information:** These four phases will each be presented in detail in parts B - E of our series in subsequent issues of the PKF Newsletter.

StB [German tax consultant] Oliver Heckner, (Section 1). WP/StB [German public auditor/ tax consultant] Daniel Scheffbuch (Section 2)

TAX

Losses on equity investments and loan losses from shareholdings in corporations in private assets

When a corporation enters a state of crisis the question that arises for investors is how can they take into account the losses on their equity investments, or losses arising from loans issued to corporations in a way that reduces their tax liability. The relevant rules can be categorised as follows, although, we have restricted ourselves to shareholdings and loans that were acquired after the 31.12.2008.

1. Losses from equity interests in corporations

In the case of investments held as private assets, taxpayers can only deduct losses once the shareholdings have been sold. A distinction has to be made between whether or not, within the period of the last five years before the sale, the size of the taxpayer's equity interest in a corporation was at least 1% at some point.

a) Equity interest below 1% - If the costs of acquiring the equity interest exceed the sale proceeds and the selling costs then a loss on the sale arises. However, this loss may only be offset against other income from capital assets (thus, interest income etc.). As income from capital assets is generally subject to withholding tax at a rate of 25% the losses will only be able to reduce the tax liability to this extent. Furthermore, losses arising from the sale of shares may only be offset against profits from the sale of shares. Losses that have not been compensated will be deducted from (future) positive income from capital assets within the framework of a loss carry-forward in accordance with Section 10d of the German Income Tax Act. If the shares are held in a custody account at a bank then the losses from the sale of shares or the negative income from capital assets will be offset accordingly against income by the financial institution. Losses that are not compensated will be carried forward by the financial institution into the following year (a so-called "loss compensation pool"). If, within the scope of his/her tax return, a taxpayer wishes to offset the amount of losses against gains from the disposal of shares from a custody account with a different bank then s/he has to ask the first bank to issue a certificate that shows the amount in the loss compensation pool.

Losses can only be offset against profits

b) Equity interest of at least 1% - In this case, a loss arising from a sale is included in business income and is subject to the partial income rule. Consequently, 60% of the loss is tax-deductible, however - unlike in the case of an equity interest below 1%, - it can be offset against all other business income as well as other types of income. Losses that are not com-

pensated will be taken into account within the framework of an income tax loss carry-back or carry-forward.

2. Loan losses

For income tax purposes, loan losses only arise once a loan has been sold, although, the Federal Fiscal Court has put loan losses that have been definitively established as a consequence of a debtor's insolvency on the same footing as the sale of receivables (PKF Newsletter 2/2018). A loan loss can only be offset against other positive income from capital assets - such as, for example, with capital gains from shares or interest income; the (remaining) loss that is not compensated (in the year concerned) can be carried forward for an unlimited period of time (loss carry-forward). If the loan losses (such as, for example, in the form of losses from the sale of bonds) arise in a securities deposit account set up at a bank, then in order to be able to offset these losses against profits from capital assets from a securities deposit account at a different bank it will, likewise, again be necessary to obtain a loss statement and to handle the issue in a tax return.

» **Please note:** At the level of the investor, the constructive equity contribution to the borrowing corporation is treated in the same way as a sale where a loss is realised; the sale price is then replaced by the fair value of the loan receivable (the so-called presumed fair value). At the level of the borrower an addition to equity (for tax purposes) in the corresponding amount will be deemed to have been made and the amount of the non-recoverable portion - if compensation with losses is not possible - will be deemed to be a taxable profit (for potential exceptions in cases of restructuring cf. PKF Newsletters 3/2017 and 5/2017).

3. Conclusion

The size of a shareholder's stake is particularly important when taking into account losses connected with equity interests in corporations. A loss on the sale in the case of a shareholding of at least 1% will result in the possibility of offsetting the loss against all types of income; however, because of the partial income rule, only 60% of the loss will be compensated. In the case of a shareholding of less than 1%, it would only be possible to offset losses against income from capital assets. Losses arising from the sale of shares may only be offset against profits of the same type. Likewise, losses from private shareholder loans may only be offset against other income from capital assets.

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

Assessed valuation in the case of real estate tax is unconstitutional

» **Who for:** Property owners and tenants.

» **Issue:** The Federal Constitutional Court, in its ruling from 10.4.2018, declared that the system of assessed valuation for property - which is used as the basis for calculating real estate tax - is unconstitutional. In the "old" German federal states the assessed values for property still date back to values from 1.1.1964 and in the "new" German federal states to 1935. These do not constitute an up-to-date assessment base for real estate tax. The judges have now asked the German government to come up with new rules by 31.12.2019 that will have to be implemented by no later than 31.12.2024.

Please note: As the real estate tax constitutes an important source of revenue for the municipalities this ruling will not lead to the abolition of this tax but instead to its reform. The German government has already announced that any reform should be revenue-neutral. A complete reassessment of the 35 million properties in Germany would appear to be unlikely for practical reasons. Instead, various models are under discussion according to which real estate tax would be assessed by means of the plot area or, for developed plots, by multiplying the costs of production by the floor area minus the decrease in value due to age.

The valuations of land and property for real estate tax purposes are no longer appropriate

» **More Information:** The ruling from 10.4.2018 (case reference: 1 BvL 11/14) is available on the website of the Constitutional Court (www.bundesverfassungsgericht.de - German version only). We will keep you informed about the now pending reform of real estate tax.

WP/StB [German public auditor/ tax consultant] Dr. Matthias Heinrich,

The digital permanent establishment as a point of reference for taxation in the EU

» **Who for:** Businesses in the digital economy.

» **Issue:** On 21.3.2018, the EU Commission put forward proposed directives on the taxation of the digital economy. The aim is fairer taxation of the digital and the "analogue" economies.

Under tax law, the existence of a "permanent establishment" determines the state in which taxes will be payable. While it is comparatively easy to determine the existence of a permanent establishment with places of business, such as sales outlets or factories, in the case of digital services there is considerable uncertainty. Thus, for example, in the case of a streaming service it is unclear whether the provider's server or the customer's end device constitutes a permanent establishment under tax law.

The modern interpretation of a permanent establishment begins with the end user

In order to solve this problem the EU Commission is following two approaches:

(1) In the long term, the EU Commission plans to introduce a type of "digital permanent establishment" and thus regulate the revenue from income tax.

A business will be deemed to have a digital presence if it:

- generates sales of more than € 7 m with digital services in an EU state,
- has more than 100,000 users for its digital services in a Member State, or
- completes more than 3,000 contracts for digital content per year.

(2) As an interim solution a digital sales tax will be implemented in the short term. This will only affect businesses with group revenues of at least € 750m of which at least € 50 m are generated in EU states. If these criteria are fulfilled then the sales generated with digital services (e.g. online advertising space) will be taxed at a rate of 3%.

RAin StBin [German lawyer and tax consultant] Dany Eidecker

The German anti-treaty shopping provision (Section 50d(3) of the German Income Tax Act) infringes EU law - The Federal Ministry of Finance has relented

» **Who for:** Businesses that operate across borders.

» **Issue:** With its anti-abuse provision in Section 50d(3) of the German Income Tax Act (*Einkommenssteuergesetz*, EStG) the German government has sought to thwart the practice of involving intermediary companies in order to exploit beneficial tax rules.

In this respect, the ECJ, in it ruling from 20.12.2017 (case references: C-504/16 and C-613/16) decided that the rules in Section 50d(3) EStG that prevent the deduction of German withholding tax being circumvented through cross-border tax structuring measures (treaty shopping or directive shopping) infringe EU law (PKF Newsletter 2/2018). The Federal Ministry of Finance (*Bundesministerium der Finanzen, BMF*), in its circular from 4.4.2018, has responded to the ECJ decision and set out the consequences for the old as well as the new rules (from 2012) in Section 50d(3) EStG. By way of background it should be noted that so-called "treaty shopping" seeks to exploit the benefits of a double taxation agreement (DTA) by using intermediary companies, while "directive shopping" aims to make use of the advantages under the Parent-Subsidiary Directive (PSD) or the Interest and Royalties Directive (IRD).

» **Example:** A shareholder based in a country without a DTA has a stake in a corporation based in Germany. The profit distributions from the corporation are subject to withholding tax at a rate of 25% plus the solidarity surcharge at 5.5%. By transferring the stake to a holding company based in country with a DTA it could potentially be possible to reduce the capital gains tax on profit distributions down to 0% under a favourable DTA or on the basis of the PSD.

Under the rules in Section 50d(3) EStG, foreign enterprises are essentially disallowed from taking advantage of the concessions available under a DTA, the PSD or the IRD if the income of the foreign enterprise does not derive from its own business activities. The BMF has now determined, in the above-mentioned circular from 4.4.2018, that the anti-abuse rules should no longer be applied to old cases (up to 2011) where a foreign enterprise has claimed a refund of or an exemption from capital gains tax on the basis of the PSD. For current cases, the substance requirements under Section 50d(3) EStG, in particular, have been significantly reduced.

» Recommendation: In cases where businesses have previously refrained from filing an application for an exemption from or a refund of withholding tax on capital gains, the chances of success with respect to an exemption or a refund should be reassessed (before the statute of limitations on tax assessments expires).

» More Information: Currently, there is an appeal pending at the ECJ in respect of proceedings concerning possible infringement of EU law by the new rules in Section 50d(3) EStG (case reference: C-440/17).

RA StB [German lawyer and tax consultant] Reinhard Ewert

ACCOUNTING & FINANCE

Disclosure obligations - Using the simplifications afforded by the exempting consolidated financial statement

» Who for: Group corporations with profit transfer agreements that wish to make use of the simplifications afforded by the exempting consolidated financial statement.

» Issue: According to Section 264(3) of the German Commercial Code (Handelsgesetzbuch, HGB) a subsidiary corporation that is included in a consolidated financial statement has the option of benefiting from the exemptions with respect to the drawing up, auditing and disclosure of an annual financial statement. In particular, instead of a single-entity financial statement for the subsidiary only an (exempting) consolidated financial statement and management report as well as the auditor's report have to be published. Information about the exemption of the subsidiary corporation needs to be provided in the notes to the consolidated financial statement along with the disclosure of the approval for the exemption by the shareholders of the subsidiary company for the respective fiscal year. Furthermore, under the Accounting Directive Implementing Act (Bilanzrichtlinien-Umsetzungsgesetz, BilRUG), for the first time, there will be a requirement for a parent company to publish a statement in the annual financial statements for the 2016 fiscal year to the effect that it is prepared to guarantee in the subsequent fiscal year the commitments entered into by its subsidiary company up to the reporting date.
The Committee on Legal Affairs in the legislative procedure for BilRUG and the IDW (the Institute of Public Auditors in Germany) are of the view that for the obligation to assume liabilities in accordance with Section 264(3) clause 1 no. 2 HGB it is normally sufficient for there to be statutory loss absorption pursuant to Section 302 of the German Stock Corporation Act (Aktiengesetz, AktG) that arises from a control and profit transfer agreement and the parent company's internal liability vis à vis the subsidiary company that is associated with this. However, if the declaration on the obligation to assume liabilities is not disclosed then, overall, the disclosure will be deemed to be incomplete.

» Recommendation: Following initial experiences in how the German Federal Gazette (Bundesanzeiger) has dealt with these new rules, such an error can be prevented if the shareholders' resolution approving the exemption that has to be disclosed also includes a statement about the existence of a profit transfer agreement with an obligation to absorb losses pursuant to Section 302 AktG, as amended, for the subsequent fiscal year

WP StB [German public auditor and tax consultant] CPA Max Zünkler

LATEST REPORTS

Two VAT rates for a single supply?

The ECJ, in it ruling from 18.1.2018 (case reference: C-463/16), decided that a single supply can only be subject to a uniform tax rate. This ruling was based on the principle that ancillary supplies share the tax treatment of the principal supply. Consequently, a supply should not be split in such a way so that the standard as well as the reduced tax rate can apply. The relevant rate of VAT for the entire supply is the one that is applicable to the principal element of the single supply. This will also apply even if the payment for each element of the single supply can be apportioned correctly. By contrast, under German VAT law there is a requirement to subdivide (e.g. letting out living and sleeping areas pursuant to Section 12(2) no.11 clause 2 of the German VAT Act (Umsatzsteuergesetz, UStG) or Section 4 no. 12 clause 2 UStG). At the very latest since the above-mentioned ruling it has become doubtful that these national requirements are compatible with EU law (doubts already existed at the Munich tax court, case reference: 2 V 2192/12). There has to be a review, at least, as to whether or not there are no dependent ancillary supplies that justify a split.

Deduction of work-related expenses in the case of a home office jointly owned by both spouses

If a spouse uses a jointly-owned dwelling for professional purposes then he will only be able to deduct, as work-related expenses, the property-related expenditure (e.g. depreciation and debt interest) in proportion to his co-ownership share if the loan for the acquisition of the dwelling was jointly taken out and the payment of interest and principal is made out of a joint account (Federal Fiscal Court ruling from 6.12.2017, case reference: VI R 41/15). The reason behind this is that in the case of joint owners it should be presumed that each of them bore the purchase or production costs in proportion to their co-ownership share. However, the expenses should be taken into account to the full extent as work-related costs if the joint expenses are paid out of "a single fund" for a property owned by one spouse and used by him to generate income. The amount shall be deemed to have been paid on the account of the individual who owes it.

The Federal Ministry of Finance has specified the disclosure obligations in the case of foreign relationships

Extended notification requirements for cross-border situations have been in force since 1.1.2018 for both German taxpayers as well as financial institutions (Sections 138 and 138b of the (German) Fiscal Code in the version from 23.6.2017). In a circular from 5.2.2018, the Federal Ministry of Finance laid down the required form and deadline (by the end of February of the subsequent year) for the notification. Notification has to be given of nearly all forms of foreign holdings: formation or acquisition, change, termination and the sale of foreign businesses and shareholdings in foreign professional partnerships and corporations. There will be sanctions for culpable infringements. Therefore, regular and complete notifications should be systematically ensured.

No possibility to make a correction if the declared amount of remuneration differs from the amount transmitted electronically

The Federal Fiscal Court in two rulings (case references: VI R 38/16, VI R 41/16) decided that a tax office is not allowed to make a correction under Section 129 of the (German) Fiscal Code (obvious error) if it does not compare the remuneration that has been stated (in the tax return) with the salary that was electronically transmitted by the employer and if there are differences between the data sets. In the case in question, the respective remuneration was correctly stated to be higher while the data that had been electronically transmitted and automatically accepted by the tax office showed an amount that was too low. This is an ascertainment error by the tax office that excludes a subsequent correction. In the rulings it was stressed that for the application of Section 129, among other things, it was essential to distinguish between a fact that has been overlooked on the basis of a mechanical error and an incomplete verification of the facts.

AND FINALLY...

"It's against all of our policies for an application to ever share information with advertisers."

Mark Zuckerberg, born 15.5.1984 in White Plains, New York, in an interview 12/2010.

Impressum

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