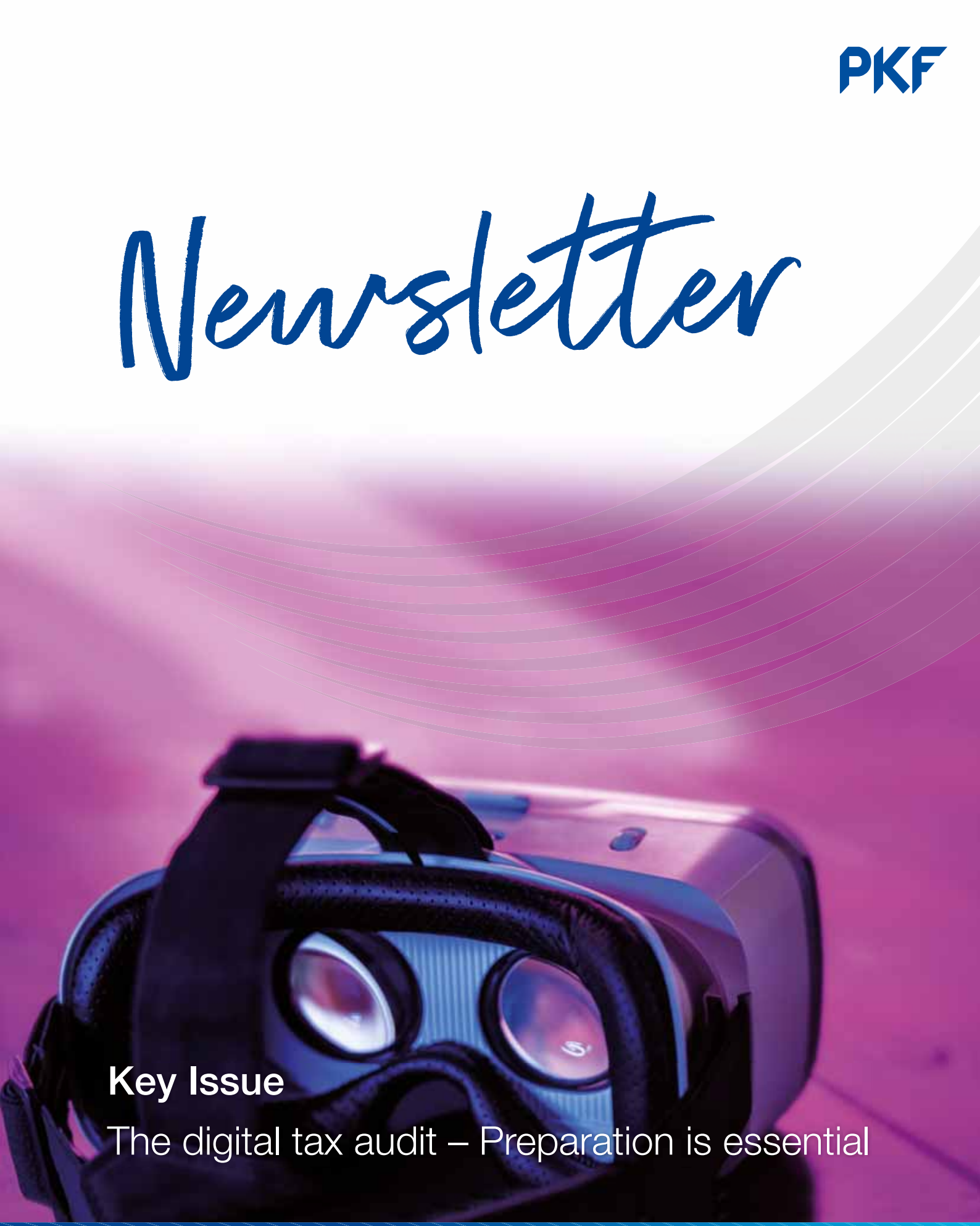
PKF

Newsletter



Key Issue

The digital tax audit – Preparation is essential

09|19

Dear Readers,

For companies, digitalisation is simultaneously a blessing and a curse. This is because, on the one hand, data are then available at all times and it is easier to perform analyses for the optimal allocation of resources yet, on the other hand, companies also become more transparent for the fiscal authorities. Against this background, for the Key Issue in this edition, we highlight what you should pay attention to in the run-up to a **digital tax audit** and how you can prepare yourself for it. PKF's Tax Compliance Management System (CMS) can be an important tool here for the analysis of risks and for the implementation of measures for guidance and monitoring. We provided an overview of the module on the (German) Principles of Proper Keeping and Retention of Accounts, Records and Documents in Electronic Form as well as Access to Data (abbreviated to GoBD in German) a year ago in our PKF Newsletter issue 07-08/2018.

On the subject of GoBD, you can find the specifications for these in the new 42-page **Federal Ministry of Finance circular on GoBD**, which we discuss in our second report. There are growing signs that these specifications, which have already existed since 2014 and have now only been slightly adapted to bring them into line with new technical developments, will be made the subject matter of tax audits in the near future. The so-called documentation of procedures is a key element here.

Digitalisation does not stop at sports either. In the third report in the Tax section, we discuss **eSports** - a form of sport that is still quite new. Moreover, from a tax perspective, we have classified the income and expenses that are generated by this sport. Two further contributions concern the recognition and the measurement of **shareholdings**. Firstly, the **allocation** of equity interests in GmbHs (German limited companies) to **business assets or to private assets** and, secondly, the question of when and to what extent **subsequent acquisition costs** - in particular, those incurred in conjunction with liability and guarantee constellations - are deemed to exist.

In the Legal section, we present an interesting and permissible structure for the transfer of business assets in cases where **tax allowances for gifts and inheritance** are supposed to be used even though the individual shareholder holds no more than 25% of the shares. The second report demonstrates the limits that have to be taken into account in the case of the **time limitation of employment contracts** for no material reason.

We wish you an interesting read.

Your Team at PKF

Key Issue

The digital tax audit – Preparation is essential

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TAX

RAin/StBin [German lawyer/tax consultant] Antje Ahlert

The digital tax audit – Preparation is essential

The tax authorities are likewise going digital. Companies are currently noticing this, in particular, during tax audits by the authorities. The deployment of digital assistance systems is frequently already common practice. During the initial phase of digital tax audits, due to the lack of experience, it was still possible to bank on the auditor still showing some leniency. However, at the present time, companies should no longer rely on that.

1. Implementation

Companies are obliged to retain tax-relevant business records, such as invoices, receipts or accounts, for ten years. However, since 2002, these records have also had to be documented electronically or digitally and, upon request, made available to the respective tax authority (Sections 146, 147 of the Fiscal Code (Abgabenordnung, AO)). These also include records such as, e.g. the asset accounts, payroll accounts or financial accounts. Further provisions can be found in the 'Principles of Proper Keeping and Retention of Accounts, Records and Documents in Electronic Form as well as Access to Data' (Grundsätze zur ordnungsmäßigen Führung und Aufbewahrung von Büchern, Aufzeichnungen und Unterlagen in elektronischer Form sowie zum Datenzugriff, or "GoBD" for short). (These were published by the Federal Ministry of Finance (Bundesministerium der Finanzen, BMF) in its circular from 11.7.2019; our next report on p. 6 takes a closer look at them).

2. Scope of the data access

The fiscal authorities may access all the digital data that are relevant for taxation. Besides the original accounting

programs, these could also be, e.g. ERP systems, cash register systems, time recording systems and document management systems. Here, there are three ways available to tax auditors for accessing data (a combination of several types of access is also permitted):

(1) There is **direct data access** if the auditor is able to directly access the in-house hardware and software that are used to carry out the accounting processes. In the course of this, the auditor will be able to read, filter and sort the data. Access authorisations will have to be provided for the auditor and s/he will have to have the possibility of evaluating all the tax-relevant data.

(2) Indirect data access assumes that the auditor will be able to issue instructions to a suitable company staff member for the provision and evaluation of internal company data. In such a case, the auditor would obtain read-only access. Moreover, the auditor may only request those data that the company's IT system is also able to provide.

(3) A **data media transfer** is characterised by the handing over to the auditor of data that are relevant for the tax audit on a machine-readable and machine-assessable data carrier (CD, DVD, USB stick) for evaluation using the authority's proprietary audit software. In this case, the fiscal authority would not be entitled to extract the data from the IT system by itself.

3. Preparing for a digital tax audit

Prior to a digital tax audit, it is recommended that you uncover the internal company strengths and weaknesses in relation to the GoBD. As part of this review, you should identify and document all the tax-relevant processes, data and programs. Here, the typical problem areas stem from electronically generated data such as, e.g. e-mails or online banking.

All the application systems that are used in the company and could potentially be relevant for a tax audit should be scrutinised so as to establish whether or not they are "GoBD" compliant. There should be appropriate certifications from the software providers. In this context, the documentation of procedures for existing systems and for all programs should be part of a mandatory policy for every business.

While preparing for a digital tax audit, if deficiencies in terms of content or form already emerge (e.g. lack of data transparency or posting errors) then these should be eliminated as quickly as possible. If this does not happen then the auditor will generally be authorised to reject the company's accounting procedures and carry out a reassessment of the net income or loss.

4. Retention and archiving requirements

Accuracy is a requirement for electronic storage. For example, incoming letters and booking vouchers have to be stored in the format in which they were also received. Here, PDF or image formats are options for invoices or statements of account. In order to satisfy the retention requirements, under certain circumstances, it is permissible to convert paper documents into an electronic format by scanning them. The requirements that have to be taken into account are specified in the GoBD. Here, the inalterability of the archived records and data should be noted. Moreover, in the case of electronic data, the same retention periods apply as exist for records in paper form. In addition, data processing systems no longer in use that, in the past, were deployed for accounting processes, have to be kept in the company for audit purposes for a period of up to 10 years.

5. Possibility of simulating a tax audit

IDEA, an analysis and evaluation program used throughout Germany, assists the tax auditors in checking company data. In doing so, the software provides auditors with different data analysis functions. In order to prepare yourself for a tax audit and not cede the data analysis field entirely to the tax auditors, you should carry out a simulation of a tax audit beforehand using the internal company data. The advantage of this is that you will be able to rectify process and data errors before they lead to problems in the "real" tax audit.

It is possible to carry out a simulated tax audit using, e.g. Microsoft's 'EXCEL' program. To this end, in an example on page 6, we have outlined a qualitative test for the completeness of digital basic records pursuant to Section 146(1) clause 1 AO. As regards the principle of completeness, – which is a key criterion for assessing whether or not the financial accounting conforms with the applicable rules and regulations – a check is made, in particular, to determine if there are digital records for all the business transactions. It should be noted here that every database system works with unique criteria.

Example: Sales transactions are given, e.g. a unique and sequential number. For the purpose of verifying compliance with the principle of completeness, a pivot table is created here from the data platform. In the process, a check is carried out to determine if the consecutive num-

bering of the sales transactions exhibits any interruptions (e.g. sales transaction 238 follows on from sales transaction 236). By means of a simple what-if function, every interruption between the individual numbers is shown with the value =1 in the adjacent cell. If there is no break in the number sequence then the value = 0 is recorded in the adjacent cell. Once the verification process is completed, the column with the values 0 and 1 is filtered and the value = 0 is hidden. As a result of this filtering only those cells with the value =1 are displayed in the table. This value indicates that two consecutive numbers are not sequential and that a business transaction that occurred in between has not been included in the data. On the basis of this report it would be possible to take further measures to clarify this situation.

Please note: This example shows that it is possible to verify your data with a reasonable amount of effort prior to the actual tax audit in order to identify problems and eliminate them in advance.

6. Costs and sanctions

The costs incurred for the digital data access will generally have to be borne by the companies. Here, the data will have to be kept in standard file formats, or alternatively it will have to be possible to convert them into these formats. Taxpayers would be responsible for purchasing any software or hardware necessary to perform such conversions.

If a business fails to comply with the requirements under the GoBD, especially those related to the digital tax audit then, depending on the offence, various sanctions would be possible. These include:

» fines,
» coercive means,
» estimates.

Recommendation

In view of the ongoing digitalisation, every business should prepare itself for the digital tax audit. Here, digital preparation creates not only security but is also increasingly an important factor in national and international competition. It is advisable to hand over data on a CD, DVD or a USB stick to the tax auditor. In that way, you will prevent the tax auditor from blocking operating resources, in the context of directly accessing data, over a longer period of time.

StB [German tax consultant] Lukas Bien

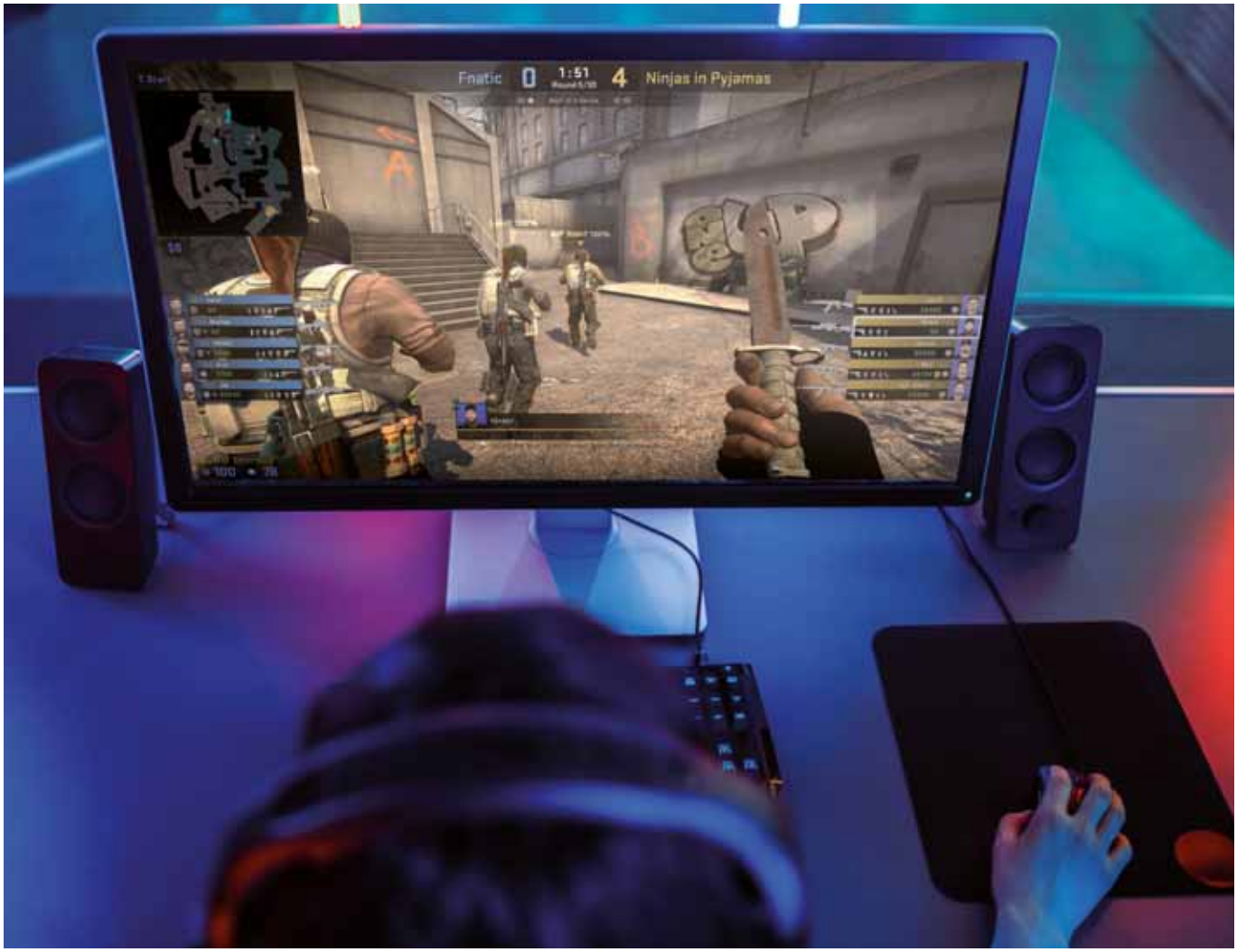
Stricter enforcement of existing and new requirements

New version of Federal Ministry of Finance circular on the ‘Principles of Proper Keeping and Retention of Accounts, Records and Documents in Electronic Form as well as Access to Data’

The fiscal authority published an amended version of the ‘Principles of Proper Keeping and Retention of Accounts, Records and Documents in Electronic Form as well as Access to Data’ *(Grundsätze zur ordnungsmäßigen Führung und Aufbewahrung von Büchern, Aufzeichnungen und Unterlagen in elektronischer Form sowie zum Datenzugriff, GoBD)* in a new Federal Ministry of Finance *(Bundesministerium der Finanzen, BMF)* circular, on 11.7.2019. This has replaced the previous guidelines from 14.11.2014. In the latest circular, the fiscal authority has described how – in the course of the ongoing digitalisation and automation wave in IT systems and processes of businesses – they would expect the requirements under the GoBD to be complied with and how these should potentially be documented.

1. Expansion of documentation obligations

The newly published BMF circular has again expanded the documentation obligations for companies with respect to the IT systems that are used for this. Moreover, the fiscal authority’s guidance has been adapted to the current state-of-the-art technology. It can be assumed that this broadening of the documentation obligations will become the subject matter of future (digital) tax audits; in this respect, we would like to refer you to the preceding report in this issue of the PKF Newsletter. Within the scope of such tax audits, it is likely that there will be requests for documents that go considerably beyond previous data access. In the following section, we enlarge upon important aspects of the documentation obligations that were published in the BMF circular.



2. Taking account of technological developments (cloud solutions, etc.)

The fiscal authority takes the view (we believe rightly so) that it is irrelevant whether the deployed data processing systems are run via a proprietary solution or a cloud solution. A simplification rule now provides for the possibility of receipts (e.g. in the context of a foreign business trip) being photographed on site “directly” using a smartphone. Based on this clarification, an open question from the BMF circular of 14.11.2014 has been resolved and has now created legal certainty for a great number of businesses.

3. Documentation of procedures

Since the fiscal authority, in the last few years, has already over and over again discussed and/ or claimed the need to document procedures in the context of regulatory changes (e.g. the Administrative Regulations Governing the Application of the German Fiscal Code to Section 153 of the Fiscal Code) extra attention should be paid to this aspect in view of the increase in current practical cases.

For example, on the basis of a special rule, power supply companies had to submit, to the competent Principal Customs Office, documentation of their procedures for electricity and energy taxes by 31.3.2019 already. For all other businesses this obligation arises from subsection 151 et seq. of the BMF circular. These provisions were indeed also included in the previous circular, however, the requirements relating to the documentation of procedures will now be enforced via the IT systems that are used in the company.

The scope of the systems that have to be documented is great. Besides financial accounting programs, many source systems are routinely deployed at companies (e.g. ERP, payroll accounting, invoicing and ordering systems, etc.) that, likewise, are of great importance for the establishment and presentation of items in the annual financial statements. Here, in order to comply with the expectations of the fiscal authority the following will have to be documented:

- the programs deployed,
- the function (if necessary, the interfaces that are used) and

» their linkage and importance for the annual financial statements.

The same also applies to the respective data flow and the subsequent processing associated with this.

Please note: Within the scope of tax audits, increasingly, enquiries are being made about the functionality of the IT systems that are deployed, about the present interfaces and the existing documentation. The extent of the documentation required in an individual case would be determined by whatever is necessary to understand the IT procedure, the accounts and records as well as the retained documents.

Recommendation

Given that missing documentation and unexplainable 'data losses' in the cash register and accounting systems that are deployed could justify a reassessment by the fiscal authority of the taxable amount, it is essential to actively address the documentation obligations that are now required by the fiscal authority.

Faruk Akkaya / WPin/StBin [German public auditor / tax consultant] Stephanie Albert

Tax aspects of eSports

More and more people are now earning their income via new information technologies. The following section discusses the extent to which so-called eSports should be viewed as sports and how, in the context of tax, the income and expenses generated with them should be classed.

1. eSports – a new form of sport?

In eSports, professional players (so-called pro gamers) compete against other pro gamers in video game tournaments and receive appearance fees for participating and prize money if they win. In addition, income is frequently generated from sponsorship agreements and streaming platforms. Both individual players as well as teams (so-called clans) take part in these tournaments, which are organised by different events companies. It is possible to play in a national league (e.g. Electronic Sports League, ESL) and international leagues. However, eSports has not yet been recognised as a sport even though this topic is hotly debated.

Please note: That is why, currently, eSports are denied both public funding as well as the indirect funding that would come if its non-profit status were to be acknowledged for tax purposes.

2. The taxation of players and clans from a national perspective ...

Generally, pro gamers who engage in eSports autonomously, and who are not bound by any instructions or directives, basically generate business income in terms of their appearance fees and prize money. The same applies to any income from sponsorship agreements or streaming platforms.

If an exchange of services subject to VAT is deemed to have taken place then the income will also be liable to VAT. While non-performance-related appearance fees will thus generally be subject to VAT, performance-related prize money does not routinely constitute an exchange of services subject to VAT.

By contrast, if the player is in an employment relationship with a clan (employer) then s/he generates income from employment.

The clans can be set up and supervised both by the players themselves as well as by companies or clubs. The tax implications for them would be determined on the basis of general principles and an assessment should be carried out separately for each individual case.

... and from an international perspective

Since pro gamers are spread all over the world – in many cases the clans are made up of international members – and eSports tournaments are held worldwide, frequently, attention also needs to be paid to aspects of international tax law.

From the German perspective, an assessment should be carried out to determine the pro gamer's (unlimited or limited) tax liability status. If the pro gamer is neither domiciled nor ordinarily resident in Germany then s/he would have restricted tax liability with respect to his/her domestic (German) income in Germany within the meaning of

Section 49 of the German Income Tax Act (*Einkommensteuergesetz, EStG*). In the case of pro gamers, domestic income would essentially arise

- as a result of setting up a (German) domestic permanent establishment,
- as a consequence of working as an employee in Germany and
- because of taking part in a tournament in Germany.

Please note: As with performers or professional sportspeople, in the case of players with restricted tax liability, withholding tax (Section 50a EStG) has to be retained if no payroll tax has had to be paid over already.

3. Outlook – The digital permanent establishment and market prospects

Against a background of the international debate about the expansion of the concept of a permanent establishment to include the digital permanent establishment, it is likely that for eSports it will be necessary to clarify the question of the point at which a digital permanent establishment will have been set up and whether or not the availability of a gaming console would possibly be sufficient for this.

The young eSports market has grown strongly in the last few years and high growth rates are expected for the coming years, too. In particular, sponsorship of eSports is being viewed by more and more companies as an opportunity to address a young target group that is difficult to reach via traditional advertising channels.

In addition, more and more voices are calling for eSports to be recognised as a sport. The Bundestag (lower house of the German parliament) is already engaging with this topic. Further developments remain to be seen.

Recommendation

It should be noted that due to the growing importance of eSports the tax authorities are now paying attention to it, too. The Analysis Unit for Risk-Based Investigations in the Area of Fiscal Supervision *(Analyseeinheit für Risikoorientierte Ermittlungen im Bereich der Steueraufsicht, ARES)*, as a special unit of North Rhine-Westphalia's regional tax office, has already started to focus on e-Sports.

StB [German tax consultant] Dennis Brügge

Shareholdings in a corporation as necessary business assets

The inclusion of shareholdings in corporations in private or business assets can be of considerable significance for business owners. How the assets are allocated would be of relevance, for example, if the issue were the taxation of the related investment income (dividends). The Federal Fiscal Court (Bundesfinanzhof, BFH), in a recent ruling, went into detail about the pre-conditions for necessary business assets for tax purposes.

1. Allocation principles

Business assets are the basis for the net worth comparison method and thus likewise relevant for determining taxable profit. Capital assets are part of necessary business assets if they are directly used for business operations and can be identified as themselves being intended for direct use in business operations .

2. Issue – A sole trader with equity interests in GmbHs (German limited companies)

The case that the BFH ruled on involved a sole trader who was the only shareholder in B-GmbH. This company held a 100% stake in A-GmbH and C-GmbH. The sole trader maintained business relationships with all the GmbHs, particularly with C-GmbH. This ultimately led to a situation where, in the relevant year, around 99% of the sole proprietorship's revenues were generated with the three GmbHs.

In his tax return, the sole trader treated the equity interest in B-GmbH as a private asset. Consequently, a profit distribution by B-GmbH was allocated to income from capital assets. By contrast, the local tax office was of the opinion that the equity interest was part of the necessary business assets of the sole proprietorship and, therefore, that the profit distribution should be taken into account as operating income.

In the first instance, the tax court found in favour of the taxpayer because as a result of the own considerable business activities of B-GmbH and its subsidiary companies this shareholding was not providing services (almost) exclusively and directly for the sole proprietorship. Moreover, the revenues and profits of the GmbH were significantly higher than those of the sole proprietorship. Therefore, the stake was not being held for reasons of commercial interest. The tax office lodged an appeal against this.

3. Commercial income with existential importance for the sole proprietorship

The Federal Fiscal Court (Bundesfinanzhof, BFH) did not share the opinion of the tax court. According to a recent ruling from 10.4.2019 (case reference: X R 28/16), in the case of sole traders, the interests held in corporations should be deemed to be a part of necessary business assets if these interests were intended to significantly facilitate commercial activity and/or sales of products and services. According to the BFH, what matters for the sales promotion aspect is the associated company's share of the revenues of the sole proprietorship. There would thus have to be enduring and intense business relationships with the associated company. This would have to be assessed from the sole trader's point of view.

In the case in question, existential importance for the sole proprietorship could safely be assumed as nearly all the revenues were generated with the corporations. This would not be precluded if the enduring and intense business relationships did not exist directly with the associated company itself but with a second-tier subsidiary (C-GmbH). Given the paramount importance of the equity interest for the sole proprietorship C-GmbH could not be assumed to be a mere investment either.

Accordingly, the upshot was that the dividend had to be attributed to income from business activities.

Recommendation

The allocation of shareholdings to taxable business assets – or else to private assets – could entail material consequences, for example, when it comes to the taxation of hidden reserves or taking losses into account. An individual assessment is usually required so that an appropriate allocation of the assets can be made and should, therefore, always be carried out in consultation with a tax advisor.

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

Subsequent acquisition costs when shareholdings in corporations are sold pursuant to Section 17 of the German Income Tax Act

The accounting treatment of the subsequent acquisition costs when shareholdings in corporations are sold pursuant to Section 17 of the Income Tax Act *(Einkommensteuergesetz, EStG)* was the subject of the Federal Ministry of Finance *(Bundesministerium der Finanzen, BMF)* circular from 5.4.2019 (case reference: IV C 6 – S 2244/17/10001). In this, the BMF dealt with the application of the three recent rulings by the Federal Fiscal Court *(Bundesfinanzhof, BFH)* on the aforementioned topic.

1. An overview of the BFH rulings

In three recent rulings, the BFH dealt with the conditions that have to be met in order to be able to presume that costs can be classified as being subsequent to an acquisition.

- Expenses for claims as a guarantor may no longer be classified as subsequent acquisition costs for the shareholding because the Equity Substitution Law *(Eigenkapitalersatzrecht)* was abolished through the Act for the Modernisation of Limited Liability Company Law *(Gesetz zur Modernisierung des GmbH-Rechts, MoMiG)* and the legal basis under Section 17 EStG thus disappeared (BFH ruling from 11.7.2017, case reference: IX R 36/15).
- Subsequent acquisition costs attributable to a selling shareholder's share in the company may not be brought about as a consequence of internally reclassifying a free surplus reserve as an appropriated reserve (BFH ruling from 6.12.2017, case reference: IX R 7/17).
- A payment made by a shareholder into the capital reserve in order to avoid calling upon a guarantee would result in subsequent acquisition costs in accordance with its shareholding (BFH ruling from 20.7.2018, case reference: IX R 5/15).

2. Extension of transitional arrangements by the fiscal authority

In the context of calculating income/losses pursuant to Section 17 EStG, the BFH rulings will in practice mostly have a negative effect. In order to reduce this impact, the BMF has made reference to the transitional arrangements that were created already in 2010. If equity-substituting financial assistance was granted up to 27.9.2017 or became equity-substituting by this date then, for reasons of legitimate expectations, the previous regulations (see BMF circular from 21.10.2010, case reference: IV C 6 – 2244/08/10001) will continue to be applied in all open cases. These transitional arrangements originally applied only for the period from 31.10.2008 to 27.9.2017 and would thus have ceased to apply.

3. Subsequent acquisition costs under Section 255 of the German Commercial Code

Under the new regulations, subsequent acquisition costs within the meaning of Section 17(2) EStG in all other cases would only be deemed to be such pursuant to the definition under German commercial law in Section 255 of the Commercial Code *(Handelsgesetzbuch, HGB)*. Here, according to the BMF, these would be, in particular, payments into the capital reserve, cash grants, the waiver of a recoverable loan receivable, other supplementary payments or additional capital contributions.

A default on a loan, expenses arising from debt capital assistance and a default with a guarantor subrogation claim will now generally no longer lead to subsequent acquisition costs for the shareholding. The same will apply when a free surplus reserve is reclassified as an appropriated reserve.

However, the situation would be different if, on the basis of a contractual agreement, a shareholder were to provide debt capital assistance similar in nature to making a contribution to business assets. Such a case would be deemed to exist, for example, in the event of an agreed subordination. Here, under tax law governing German accounting treatment, a shareholder loan would assume the function of equity capital.

Recommendation

There are currently another five appeals pending before the BFH (case references: X R 9/17, IX 9/18, IX R 17/18, IX R 13/18 and IX R 1/19) that deal with the issue of the protection of legitimate expectations arising from the BFH ruling from 11.7.2017. Since it is only the fiscal authorities that are bound by this circular, taxpayers that are affected should file for full tax deductibility in the context of income from capital assets while making reference to the pending cases.

LEGAL

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

An exemption from inheritance and gift taxes can be secured through a pooling agreement

When it comes to succession planning, in principle, companies are able to make use of exemption provisions for business assets. Accordingly, under certain terms and conditions, a transfer of business assets for no consideration would be exempt from inheritance and gift taxes. However, for shareholders of corporations (a German limited company, or GmbH, a German joint stock company, or AG, a German partnership limited by shares, or KGaA) this only applies if they hold a stake of more than 25% in a company.

Shareholders who hold stakes of 25% or less are able to benefit from tax concessions if it is possible to attribute the stakes of other shareholders to them (so-called pooling) so that, overall, the 25% threshold is exceeded.

1. Conditions for the pooling of shares

Attribution requires the shareholders to be obligated among each other

- to uniformly dispose of the shares or to transfer them solely to other shareholders who are subject to the same obligation and
- to uniformly exercise their voting rights.

2. Uniform disposition obligation

The uniform disposition requirement does not mean that the shareholders have to transfer their shares at the same time or to the same person. It would already be sufficient for the disposition obligation to be based on uniform principles. It would thus be adequate, for instance, if the shares could only be transferred to specific people, such as family members, or if a transfer required the approval of the majority of the shareholders who are bound together.

Please note: This is already covered accordingly by the articles of association of many family enterprises. Alternatively, such transfer rules can also be set out in a separate agreement (pooling agreement).

3. Exercising voting rights uniformly

The obligation to uniformly exercise voting rights can likewise be covered by the articles of association or established in a separate pooling agreement. The latter requires no particular form and can even be concluded verbally, as the Federal Fiscal Court (Bundesfinanzhof, BFH) recently decided (ruling from 20.2.2019, case reference: II R 25/16). Although, it is likely that it would then be difficult to provide proof, which is why we strongly recommend using the written form.

It is also possible for all the shareholders to set up a voting agreement so that there would not be any shareholders who were not bound together. The BFH expressly confirmed this in the above-mentioned ruling. A pooling agreement thus does not have to result in a change in control arrangements or in taking sides. All that is then required is for the shareholders to decide on a "pro forma" basis on the voting prior to the actual shareholders' meeting.

Example: A GmbH has four shareholders who each hold a stake of 25%. According to its articles of association, the disposition of shares requires the approval of the shareholders' meeting. If the shareholders now additionally conclude a pooling agreement, according to which they would be obliged to vote uniformly and document the separate voting for this in each case then, in principle, all the shares would be subject to the exemption provisions as regards inheritance and gift taxes.

Please note

The above statements apply accordingly to shareholdings in corporations of 25% or less that are held as business assets. Through a pooling agreement, these too can be transformed from being non-operating assets that are 'harmful' (detrimental from a tax point of view) into assets that are eligible for tax relief.

RAin [German lawyer] Sonja Blümel

Time limitation of employment contracts for no material reason at affiliated companies

Time limitations for no material reason are still of great importance for employers, even within groups of companies. Recently, the state labour court *(Landesarbeitsgericht, LAG)* of Berlin-Brandenburg made a landmark decision on the legal limits of fixed-term employment contracts at affiliated companies.

1. Permissible duration of time limitation for no material reason

As regards the time limitation of employment contracts, a distinction is generally made between limitation for objective and material reasons (e.g. temporary employment for a specific project only, as parental leave cover, for a probationary period, or similar) and limitation for no material reason, i.e. a pure time limitation for no objective cause. The permissible duration of time limitations for objective and material reasons depends on those reasons. By contrast, the permissible duration of time limitations for no material reason is restricted under law to an overall maximum of two years with the same employer.

Within groups of companies and group structures, it has not been uncommon for this maximum period to be effectively extended by staff first working for one company under an employment contract that was time limited for no material reason and, subsequently, respectively for another enterprise in the group of companies.

2. Limit of the abuse of the right to time restrictions for no material reason at affiliated companies

The LAG of Berlin-Brandenburg recently made a ruling, which will be drastic for employers, (from 31.1.2019, case reference: 21 Sa 936/18) on time limitations for no material reason within groups of companies.

In the case that the court ruled on, the employer, together with a research association, operated a laboratory where the claimant (C) was employed as a technical assistant in a working group. C was initially employed by the research association on a fixed term basis. She terminated this employment relationship and then concluded a new employment contract with the employer against whom the complaint was filed. This contract was time limited for no material reason but the working conditions were otherwise unchanged. The initiative for switching employers this way had come from the head of the working group

because he had wanted to ensure that C's continued employment was on a time limited basis. C's work activities did not change as a result of switching employers. The main working conditions were likewise the same. C took the view that the time limitation was not valid and that an open-ended employment relationship had been created with the employer against whom the complaint was filed. When the defendant nevertheless requested termination of the contract as at the end of the fixed term, the claimant took legal action to extend the contract for an indefinite period of time.

The LAG ruled that, in the specific case, the time limitation for no material reason constituted an abuse of the law and was invalid. As a result of the invalid time limitation an open-ended employment relationship was thus created with the defendant. This was because there had been no objective reason for switching employers – the working conditions had remained the same, it had simply been the employer and the time limitation that had changed. The fact that both the previous employer and the one against whom the complaint was filed operated in the area of research was of no legal relevance here. In fact, the sole purpose of switching employers had been to circumvent the legal restrictions on time limitation for no material reason in a way that committed an abuse of them.

Recommendation

With regard to the time limitation of employment contracts for no material reason, in cases of switching among affiliated companies from one employment relationship to another employment relationship, you should bear in mind that while such constellations have not generally been excluded, nevertheless, they will now be under the close scrutiny of the courts. In the future, increased caution will be required in such cases. You should avoid arrangements comparable to those in the case in question. If you have any questions on this topic then please do not hesitate to contact your PKF consultant.

LATEST REPORTS

StBin [German tax consultant] Sabine Rössler

Issues related to the application of the Investment Tax Act

The Federal Ministry of Finance *(Bundesministerium der Finanzen, BMF)* addressed issues related to the application of the Investment Tax Act *(Investmentsteuergesetz, InvStG)* – which has been in force since 1.1.2018 – in its circular from 21.5.2019 (case reference: IV C 1 – S 1980-1/16/10010), which is 152 (!) pages long.

Those affected are investment funds and their investors. Besides an explanation of relevant terms, the BMF also addressed, in particular, issues related to:

- the taxation of funds,
- the collection and, as the case may be, refunding of capital gains tax,
- investment income as well as
- income that arises when investment assets are liquidated.

StBin [German tax consultant] Isabee Falkenburg

Real estate transfer tax pitfall when land and property are acquired by bequest

In his will, a testator had specified that a beneficiary under the will was entitled to purchase from the legal heir land and property belonging to the estate of the deceased on terms that had yet to be negotiated (so-called purchasing right bequest). The Federal Fiscal Court *(Bundesfinanzhof, BFH)*, in its ruling from 16.1.2019 (case reference: II R 7/16) recently decided that such a purchase is subject to real estate transfer tax (RETT) and is not exempt from it as a transfer by last will. The purchase agreement concluded between the beneficiary under the will and the legal heir would constitute the legal grounds for the acquisition. RETT can be avoided if the bequest grants the right to transfer ownership of the land and property and precisely not the right to conclude a purchase agreement. If the beneficiary under the will obtains a direct right then even a subsequent notification of the exercise of this by the beneficiary would only lead to a condition precedent of the right to transfer ownership and not to legal grounds other than a bequest. An indicator for a bequeathed right to transfer ownership of land and property can be, for example, that the testator had already determined a specific purchase price.

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

Deduction of work-related costs when counterfeit money has been accepted

The Hessian tax court, in its ruling on 13.3.2019 (case reference: 9 K 593/18), decided that counterfeit money that is accepted in the course of a business-related money exchange transaction can constitute a valid work-related deduction. The legal action was brought by a member of staff employed in sales on a commission basis. In the course of a money exchange transaction that preceded the purchase of machines, counterfeit money was slipped in between the notes that were given to him.

The local tax office refused to accept the work-related deduction in the amount of the corresponding loss that was claimed by the claimant. The Hessian tax court upheld the case because the loss suffered by the claimant was solely work related. If the sale of the machines had been realised then the claimant would have received a commission. There was thus the requisite causal link between the money exchange transaction and the commission. The work-related reason did not preclude having the money exchange transaction prior to the actual purchase agreement. Likewise, the claimant's lack of commercial sense and his negligence were not detrimental (from a tax point of view) to the work-related deduction.

Please note: The tax court ruling is not yet final and thus not yet legally binding. Further developments remain to be seen.

StBin [German tax consultant] Sabine Rössler

Disclosure requirements in the case of dealings involving foreign jurisdictions

Under Sections 138(2) and 138b of the (German) Fiscal Code, German taxpayers are required to notify their tax office of any dealings involving foreign jurisdictions. Such a notification should generally be submitted, together with the tax return, 14 months after the end of the tax period, at the very latest. The following, in particular, have to be reported: the founding, acquisition or disposal of businesses or holdings abroad. To this end, the tax authority, in the Federal Ministry of Finance circular from 21.5.2019 (case reference: IV B 5 – S 1300/07/10087), has published a new form for fulfilling the notification obligation. The old form should no longer be used. A catalogue with commercial activities of the foreign entity and an explanatory help field that can be searched have also been introduced.

AND FINALLY...

"In the end, all business operations can be reduced to three words: people, product, and profits. People come first. Unless you've got a good team, you can't do much with the other two"

Lee Iacocca, 15.10.1924 – 2.7.2019, US American automobile industry executive and co-developer of the Ford Mustang.

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