PKF

Newsletter

Key Issue:
Legislative tax proposals of the ‘traffic light’ coalition

12|21

Dear Readers,

Germany's newly designated government presented its 177-page coalition agreement at the end of November. Scattered throughout this document are the numerous **tax changes planned by the 'traffic light' coalition**. Many of these are then likely to be put into law in the coming year. In the Key Issue section of this edition of our newsletter we have summarised the most important points.

In our second report in the Tax section, once again, we discuss the specific aspects of the **option model**. If a partnership elects to exercise the option to be treated as a corporation for tax purposes, then a number of issues will arise if the **partners are residents in foreign countries**. Problems could then occur here, in particular, if the foreign country does not accept the corporation classification for tax purposes.

The third article deals with a **change in the law** that is relevant for **consolidated tax groups in all cases**; however, rather less attention was paid to this when the German Act on the Modernisation of Corporation Tax Law was passed because the focus was on the option model. Yet, there could be considerable effects in the course of the change in the system with respect to the reversal of **special items positions created to balance out differences arising from overpayments and underpayments** of profit transfers in the context of a consolidated tax group.

The other two contributions deal with recent Federal Fiscal Court rulings that, in both cases, were favourable for taxpayers. In the first ruling, the Court stated its opinion on the **arm's length comparison** and decided that, in the case of **shareholder loans**, subordination and the waiver of collateral may likewise be compensated through **higher interest rates**. In the second ruling, the Court clarified that, if certain conditions are met, changes in exchange rates may lead to an increase in foreign currency liabilities.

In the Legal section you will find a recent ruling on the question of whether or not **time spent travelling or changing clothes counts as working time or is a private matter.**

We continue our journey around the PKF locations in Germany with a visit to **Nuremberg**. Our pictorial survey of the city should actually have included images of the world-famous Nuremberg Christmas Market. In view of the ongoing pandemic and the fact that, in many places, Christmas markets did not take place during the second week of Advent we omitted these from our illustrations.

We would like to wish you and your families a lovely Christmas season combined with the hope that 2022 will be a better year.

Your Team at PKF

Front cover photo: Imperial Castle and St. Sebald Church, Nuremberg

Key Issue

Legislative tax proposals of the 'traffic light' coalition

Contents

TAX

WP/StB [German public auditor/ tax consultant] Daniel Scheffbuch

Legislative tax proposals of the 'traffic light' coalition

The parties in the 'traffic light' coalition (SPD, Greens and the FDP) presented their coalition agreement on 24.11.2021. This also contains numerous tax changes. In the following section we give an overview of the most important planned regulations.

1. Changes related to businesses

- Review to determine if workable adjustments need to be made to the option model and the so-called taxation of retained profits (please note: our reports on the option model in this and in previous issues of the newsletter demonstrate that this is the case).
- Extension of the extended loss offset (€10m instead of € 1m) until the end of 2023 and spreading of the loss carry-back to the two immediately preceding tax assessment periods.
- 'Super depreciation' on investments in climate protection and digital capital assets that are made in 2022 and 2023.
- Initiatives aimed at introducing global minimum taxation and constant updating of the list of tax havens.
- Appropriate taxation of income flows out of Germany, while aiming to prevent both non-taxation as well as double taxation.
- Prevention of tax structures through the expansion of withholding tax rights, in particular, by making adjustments to double taxation agreements.
- Supplementing the 'interest barrier' by adding an 'interest rate level barrier'.
- Implementation of the OECD anti-tax avoidance rules for the international exchange of information on financial accounts (CRS and FATCA) and the expansion of the exchange of information.
- Extension of the disclosure obligations for tax arrangements (DAC 6) to the national tax arrangements of businesses with revenues of more than € 10m.
- Modernisation and speeding up of tax audits, in particular, through improved interfaces, standardisation and the meaningful use of new technologies. Setting up a central organisational unit at the federal level to ensure that the tax administration is able to adapt to the digital transformation and to reduce tax bureaucracy.
- Promotion of employee share ownership by, among other things, further increasing the tax allowance.
- Tax incentives and investment allowances for producing affordable housing with social restrictions.
- Simplification of the process of making in-kind donations to non-profit organisations in order to prevent the destruction of such goods.
- Introduction of a nationwide electronic reporting system that will be used for the preparation, verification and forwarding of invoices (so-called e-invoicing). The aims in this respect are the prevention of fraud as well as the modernisation and de-bureaucratisation of the interface between the administration and businesses. At the EU level, the coalition wants to advocate for a definitive VAT system (e.g., reverse charge).
- Further development of the import sales tax in order to achieve a level playing field for European competitors.
- Strengthening of inclusion businesses by, among other things, formally enshrining tax privileges in VAT law.
- Implementation of the so-called plastic tax - allocation of the plastic charge to manufacturers and distributors.

2. Measures relating to all taxpayers

- Simplification of tax returns and digitalisation of the taxation procedure.
- Tax relief for plug-in hybrid vehicles to focus more strongly on the purely electric mileage. In future, hybrid vehicles would be tax privileged only if the vehicle is propelled predominantly (more than 50%) in pure electric drive mode.
- Extension and, where necessary, revision of the tax regulations for employees with respect to working from home up to 31.12.2022.
- Increase in the flat-rate saver's allowance to € 1,000 or, in the case of a joint assessment, €2,000 as of 1.1.2023.


Church of Our Lady

» Increase in the straight-line depreciation for new residential construction from 2% to 3%.

» Intensification of the fight against tax evasion and tax avoidance.

» Prevention of double taxation of pensions.

» Enabling the flexible structuring of real estate transfer tax at the level of the Länder [Federal States] in order to facilitate the purchase of owner-occupied housing.

StB [German tax consultant] Thorsten Haake

New option model for partnerships – Part IV – The option under Section 1a of the 'KöMoG' in the light of international tax law

In the previous reports in our series of detailed explanations of the German Act on the Modernisation of Corporation Tax Law *(KöMoG)* we provided information on the basic principles of exercising the option, the real estate transfer tax aspects as well as the particularities that apply to the treatment of special business assets. In this Part IV we discuss selected international aspects of the option to be treated as a corporation for tax purposes. In the course of this, the circular on exercising the option, of 10.11.2021, which was recently published by the Federal Ministry of Finance *(Bundesministerium der Finanzen, BMF),* will be taken into account.

1. Application of double taxation agreements

Partnerships, by virtue of their fiscal transparency, are normally not 'corporations' within the meaning of double taxation agreements (DTAs). In such a case, the application of a double taxation agreement has to be on the basis of the residency of the direct or, possibly, indirect shareholders insofar as these are 'persons' (i.e., natural persons, companies or associations of persons).

In the view of the fiscal administration, for the purposes of applying a DTA, the company that has elected to exercise the option is a legal entity that is treated as a legal

person for tax purposes (cf. BMF circular, of 10.11.2021, margin no. 54). Consequently, it has to be regarded as a 'corporation' within the meaning of a DBA. If the place of the management of the corporation is Germany, then, according to the respective DTA, it is also domiciled in Germany.

This strict view, from a German perspective, might not be one that is shared by all countries with whom Germany has concluded DTAs. This could lead to disputes over the classification of specific types of income. In order to prevent the non-taxation of income arising out of this, in the course of the introduction of the option, a new Section 50d(14) was created in the Income Tax Act *(Einkommensteuergesetz, EStG)* with the aim of ensuring the taxation of dividends and gains from disposals in Germany by way of a treaty override. This means that Germany will implement taxation if the other country makes an assessment that deviates from the one under the German legislation and, therefore, waives taxes.

2. Capital gains tax relief for foreign shareholders

Under Section 1a(3) sentence 5 of the Corporation Tax Act *(Körperschaftsteuergesetz, KStG)*, the profit shares from a company that has elected to exercise the option will only be deemed to have been distributed if the payment has occurred or may be claimed. The capital gains tax that arises on the distribution date has to be declared and paid to the competent tax office by the company that has elected to exercise the option.

Unlike a shareholding of at least 10% in a 'normal' corporation with unlimited tax liability, in relation to companies that elect to exercise the option there is no provision under the law for their shareholders to be able to apply for a certificate of exemption. Therefore, first of all, capital gains tax at the statutory rate would be incurred. Any reduction in capital gains tax would then have to occur in a subsequent step.

It should be noted here that, in the view of the fiscal administration, a company that has elected to exercise the option would not meet the requirements for it to be treated as a 'subsidiary company' within the meaning of the Parent-Subsidiary Directive (Directive 2011/96/EU) (BMF circular of 10.11.2021, margin no. 52). Consequently, it would not be possible to reduce the capital gains tax to 0%.

Please note: It remains to be seen whether or not this view will be confirmed by an ECJ ruling if respective proceedings are brought before the court.

Therefore, essentially, there remains the possibility of applying for a refund of the capital gains tax by referring to the section on dividends in the respective DTA. However, this presupposes that the other country would regard the company that has elected to exercise the option as a taxable entity subject to corporation tax and would tax the profit distribution accordingly. If the other country continues to act on the assumption that the organisation is a transparent partnership and waives taxes, then Section 50d(14) sentence 1 EStG would apply (see segment 1 above). As a result, Germany would secure at least the full amount of withholding tax on the profit distribution.

3. Issues related to taxable disjunction

3.1 Exit tax (Section 6 of the External Tax Relations Act *[Außensteuergesetz, AStG]*)

The general aim of the option is for the company that has elected to exercise the option to be treated as a corporation for income tax purposes. Furthermore, "for income tax purposes, a shareholding in the company that has elected to exercise the option will be deemed to be a shareholding of a non-personally liable shareholder in a corporation" (Section 1a(3) sentence 1 KStG).

The tax administration has concluded from this that all the regulations under the relevant laws (e.g., KStG, EStG, Trade Tax Act *[Gewerbesteuergesetz, GewStG]*, Reorganisation Tax Act *[Umwandlungssteuergesetz,UmwStG]*, AStG) are applicable if they pertain to all corporations regardless of their specific legal form (BMF, margin no. 50). This would also expressly apply for the exit tax regulated in Section 6 AStG (BMF, margin no. 62).

Recommendation: Thus, if taxpayers with unlimited tax liability have significant shareholdings - within the meaning of Section 17 EStG - in the company that has elected to exercise the option then any potential re-location to a foreign country would also have to be carefully considered from the point of view of Section 6 AStG.

3.2 Retention periods in Section 22 UmwStG

Under a statutory direction in Section 1a KStG, the transition to corporation tax is deemed to be a change of legal form within the meaning of the UmwStG. As a consequence, all the relevant provisions of the UmwStG have to be applied. Besides the requirements in Section 1 UmwStG that relate to the shareholders and the legal entities to be transformed, these also include the regulations in Section 20 ff. UmwStG, in particular, with regard to exercising the option to roll over the carrying amounts and to the retention periods that are triggered as a consequence.

New Museum for Art and Design, Nuremberg

If, in connection with exercising the option, the hidden reserves in the company's business assets are not fully realised then, pursuant to Section 22(1) and (2) UmwStG, a seven-year retention period will start; during this period, a sale of the shares in the company (or if specific substitute realisation situations materialise) would trigger retroactive taxation of the hidden reserves. Here, the so-called 'contribution gain' on the date the option is exercised would be reduced by 1/7th for each completed year.

3.3 Shareholders abroad

Rolling over the carrying amounts in connection with exercising the option would then also be possible if some or all of the shareholders are resident in a foreign country on the date the option is exercised. However, for this, specific requirements would have to be complied with, namely, either at the level of the shareholders or, in respect of the right to tax, of the shares in the company that has elected to exercise the option.

(a) Shareholder level

- domicile or place of habitual residence in the EU or EEA (natural persons), or
- incorporation in accordance with the law of an EU/EEA country as well as headquarters and management in an EU/EEA country (corporation)

b) alternatively, no exclusion or restriction of Germany's right to tax the capital gain from the sale of shares.

Therefore, on the one hand, compliance with the respective EU/EEA references by the shareholders would be sufficient in order to enable a tax-neutral option. On the other hand, if shareholders are resident in a third country this would likewise not be considered to be detrimental (from a tax point of view) if Germany's right to tax the capital gain from a sale of the shares is maintained.

Please note: This also means that, for example, the move from Germany to an EU/EEA country by a shareholder of a company that has elected to exercise the option would generally not however constitute a breach of the retention period; it is likewise possible that a move would trigger legal consequences under Section 6 AStG (see segment 3.1 above).

3.4 The interaction of Section 22 UmwStG with Section 6 AStG

As indicated above, various exit tax rules could potentially be applicable in parallel. In the final section, we have provided examples in order to make it clear how these rules could interact with each other.

Example: The taxpayer S moves from Germany to the UK almost 3 years after the option was exercised.

Outline solution

» First of all, subsequent taxation is triggered in the amount of 5/7ths of the hidden reserves (Section 22 UmwStG; reduction by 2 full-year periods = 2/7ths).

» The taxed amount is deemed to be the subsequent acquisition cost for the shares.

» The next step involves checking the applicability of Section 6 AStG.

» Should Section 6 AStG be applicable, then the calculation of the notional capital gain from the sale - within the meaning of Section 17 EStG - would have to include the subsequent acquisition costs from the subsequent taxation of the hidden reserves; this means that multiple taxation of these hidden reserves would be prevented in this respect.

WP/StB [German public auditor/ tax consultant] Kevin Kuß

The new ‘contribution solution’ for overpayments and underpayments of profit transfers in the context of a consolidated tax group pursuant to the Act on the Modernisation of Corporation Tax Law

Apart from the much-discussed introduction of an option for partnerships to be treated as corporations for tax purposes, the Act on the Modernisation of Corporation Tax Law *(Gesetz zur Modernisierung der Körperschaftsteuer, KöMoG)* also entails a number of other important changes. One of these involves a shift away from the previous balancing item solution for parent entities in the context of consolidated tax group relationships. Legislators have replaced the previous method with the so-called contribution solution. This raises questions about the specific consequences that will arise from this change in the system.

1. Background

In the context of cases of consolidated tax groups for income tax purposes, there are routinely differences between the accounting profit, which is transferred to the parent entity within the scope of a profit transfer agreement, and the taxable profit. If the accounting profit that was transferred exceeds the tax-relevant result then this is referred to as an overpayment and, the other way round, as an underpayment. There may be various reasons for such differences between the accounting earnings and taxable earnings. Some possible ones are, for example:

» differences in the useful lives on which depreciation is based in the financial accounts and the tax accounts,

» capitalisation of different acquisition and production cost components, or else

» the fact that it is not possible to include a provision in the tax accounts at the same level that it was created in the financial accounts.

Please note: The new contribution solution pursuant to KöMoG is targeted exclusively at overpayments and underpayments of profit transfers between members of a consolidated tax group. The new rules however have no implications for overpayments and underpayments of profit transfers during the period prior to tax consolidation.

2. Previous provision on overpayments and underpayments of profit transfers between members of a consolidated tax group

According to the regulations up to now, if there has been an underpayment between members of the tax group then the parent entity has to create a deferred tax asset balancing item in its tax accounts and in the case of an overpayment a deferred tax liability balancing item. At the parent entity – over time and commensurately with the amounts reported by the subsidiary – these balancing items are built up and reduced. At the level of the subsidiary, these overpayments and underpayments of profit transfers, in the context of a consolidated tax group, result in withdrawals and additions to contribution accounts for tax purposes pursuant to Section 27(6) of the Corporation Tax Act *(Körperschaftsteuergesetz, KStG)*.


Imperial Castle

3. New regulations under KöMoG (contribution solution)

The so-called contribution solution will apply to the overpayment and underpayment of profit transfers between members of a consolidated tax group that take place after 31.12.2021. This means that underpayment of profit transfers in the context of a tax group will result in a contribution by the parent entity to the subsidiary and overpayment of profit transfers will result in a repayment of a capital contribution. Overpayments and underpayments of profit transfers will increase and reduce, respectively, the carrying amount of the equity investment for the subsidiary in the parent entity's tax accounts and, correspondingly, the contribution account for tax purposes at the level of the subsidiary.

Please note: Contrary to the previous approach, the carrying amount of the equity investment in the parent entity's accounts has to be fully adjusted (thus not in proportion to the size of the equity investment). In the case of overpayments of profit transfers, the subsidiary's contribution account for tax purposes would be directly reduced, although this would not give rise to income from investments. Furthermore, overpayments of profit transfers in the context of a consolidated tax group would primarily reduce the contribution account for tax purposes in priority to other payments.

4. Transitional provisions

As of 1.1.2022, no more tax balancing items may be created in the parent entity's tax accounts for the overpayment and underpayment of profit transfers. Existing balancing items will have to be reversed in the first financial year that ends after 31.12.2021.

In the tax accounts, a balancing item on the assets side has to be reversed against the carrying amount of the equity investment in a profit-neutral way (accounting asset swap). However, there would generally be a risk of an immediate effect on the profit if the amount of the balancing item on the liabilities side was greater than the sum of the carrying amount of the equity investment and the balancing item on the assets side. The partial income method or Section 8b KStG would then apply. With respect to the excess amount, legislators have however granted taxpayers the option of creating a provision that has to be reversed and the reversal evenly recognised in the income statement in the year in which it was created and the nine subsequent financial years (one tenth in each case). If the equity investment is sold or if an event similar to a disposal occurs (e.g. a reorganisation, or a constructive equity contribution) then this would result in the recognition in the income statement of the complete reversal of the amount of the provision still existing at that

time. In the case of the reversal of the provision, the partial income method or Section 8b KStG would likewise come into effect.

Please note: With respect to the amount of the provision that is created, taxpayers will be able to exercise the option on an individual basis up to the level of the excess amount.

5. Conclusion and Outlook

Legislators wanted to simplify the complex system of balancing items that was giving rise to various issues. However, the transition to the contribution solution has prompted fresh discussions. For example, critics believe that the new regulations, among other things, disregard the income realisation principle because income is realised by the reversal of balancing items on the liabilities side even though no sale or an event similar to a disposal has occurred.

Furthermore, there is compulsory taxation of hidden reserves although it is unclear if they even still exist at the time that the tax is imposed. In this way, taxpayers are deprived of the possibility, at least, of using tax deferral structures for hidden reserves realised in the past. There is likewise still no consensus on how indirectly consolidated tax groups should be treated under the new regulations of the KöMoG. From the wording of the law it is possible to derive the question as to whether the overpayment and underpayment of profit transfers in the context of a consolidated tax group results in a direct contribution or a repayment of capital contributions between the parent entity and subsidiary or across the entire shareholding chain.

Please note

Overall, it remains to be seen how these discussions will develop and what response, if any, they will elicit from the German legislature - we will keep you updated accordingly.

WP/StB [German public auditor/ tax consultant] Daniel Scheffbuch/ Christina Schultz

Interest rates for shareholder loans under scrutiny at the Federal Fiscal Court

Generally, the interest rate at which a shareholder grants a loan to their company has to be compared against an arm's length benchmark. Frequently, in discussions with fiscal authorities, it is disputed whether or not a shareholder loan stands up to an arm's length comparison, or whether or not the interest charged is too high and, thus, constitutes a constructive dividend.

1. Appropriate level of interest as the subject of contention

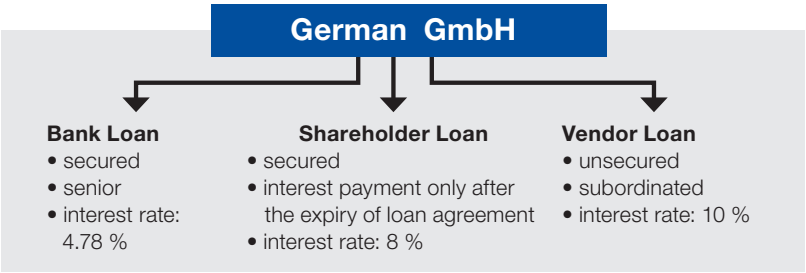
In the case that reached the Federal Fiscal Court *(Bundesfinanzhof, BFH)*, the legal action was brought by a German GmbH [a limited liability company] that had had taken out three loans in order to finance a corporate acquisition; the arrangements in terms of maturity, loan interest rate and collateral were different for each loan (cf. graphic on p.11).

The GmbH deducted the interest expense for the shareholder loan as business costs. The tax auditor was of the opinion that the interest rate of 8% that had been agreed in the loan contract concluded with the parent company was not appropriate. The arm's length interest rate was 5% and - despite the different maturity and collateral - the bank loan had to be used as a basis and the rate had to be adjusted accordingly. The difference between the interest expense that had been posted and the appropriate one had to be regarded as a constructive dividend.

2. The Cologne tax court accepted the constructive dividend assessment

The legal action taken by the GmbH against the amended tax assessment was unsuccessful at first. The tax court, in its ruling of 29.6.2017, endorsed the view of the local tax office (case reference: 10 K 771/16). A portion of the interest payments constituted a constructive dividend because the interest rate agreement for the shareholder loan did not stand up to an arm's length comparison.

The benchmark was the interest rate of 4.78% for the bank loan. According to the Cologne tax court, neither the subordination for insolvency purposes of the shareholder loan nor the absence of collateral would lead to the elimination of this benchmark. Consequently, adding a risk premium when determining the interest rate was not justified. The



vendor loan, which was likewise unsecured, - and had been granted by an unrelated third party - was also not relevant for the level of the arm's length interest rate, even though it had a higher rate of interest despite the shorter maturity. In the opinion of the Cologne-based judges who rule on fiscal matters, it was possible that the different sets of interests here (e.g. reduction in the purchase price) had had an impact on the rate that was charged.

3. The BFH called for a differentiated approach

The BFH, in its ruling of 18.5.2021 (case reference: I R 62/17) did not endorse the view of the Cologne tax court. A secured senior bank loan is not a benchmark for a shareholder loan. An unrelated third party would only accept a comparable degree of agreed subordination for insolvency purposes if, in return, it was compensated for accepting this disadvantage and the greater risk.

Furthermore, the notion that an unrelated third party would agree the same interest rate for an unsecured subordinated loan as for a secured senior bank loan is, in fact, contrary to the principles derived from experience. With its decision the BFH clarified that the lack of loan collateral is generally associated with a higher rate of interest being charged on the loan; in effect, the court has thus acknowledged that there is a connection between the risks associated with a loan and the interest that is received for this.

Please note

According to the BFH ruling, the comparable uncontrolled price method should initially be used as the basis for determining if an agreed interest rate for a shareholder loan satisfies the arm's length principle. Essentially, this requires identical supply relationships and that is why individual adjustments might be necessary.

WP/StB [German public auditor/ tax consultant] Daniel Scheffbuch/ Christina Schultz

Write-ups in the case of foreign currency liabilities

Generally, foreign currency liabilities have to be measured at their value at the time when they were created (acquisition rate). Recently, the Federal Fiscal Court *(Bundesfinanzhof, BFH)* had to decide in two cases on the conditions under which a write-up would be permissible.

1. Foreign currency-related cases

(1) In its ruling of 10.2.2021 (case reference: IV R 18/18), the BFH had to make a decision on a foreign currency loan that a GmbH & Co. KG [German limited partnership with a limited liability company as a general partner] had taken out in Swiss francs, in 1999. By the balance sheet date (31.12.2010) the exchange rate of the Swiss franc to the Euro had gone up considerably. This had correspondingly led to an increase in the amount repayable in Euros. The company was of the opinion that the increase in the exchange rate could be presumed to be a permanent increase in value and wrote up the value of the liability to the current value.

(2) In a second case, of 12.11.2020 (case: XI R 29/18), the BFH had to rule on a similar situation where, in 2008, a GmbH [a German limited liability company] had recorded a foreign currency loan in Swiss francs at an exchange rate of CHF 1.555 per €. During the subsequent period, the exchange rate of the Swiss franc to the Euro rose sharply. Furthermore, the Swiss National Bank (SNB) announced that it would no longer tolerate a rate of below CHF 1.20 per €. Consequently, the GmbH increased the value of the foreign currency liability in its 2011 balance sheet to the value that was current at that time.

2. Not a permanent increase in value in the view of the fiscal administration

According to settled case-law, foreign currency liabilities may only be reported in the tax accounts at a value that is higher than the one based on the acquisition rate if the changes to the exchange rate that have occurred by the respective balance sheet date are presumed to be permanent. In both the cases described above, the

competent local tax offices took the view that the value increases could not be presumed to be permanent; that is why the write-ups of the foreign currency liabilities were not accepted.

3. A permanent increase according the BFH decision

The BFH came to a different conclusion. In the case of long-term foreign currency liabilities, normally, variations in the exchange rate are not presumed to be permanent because, up to the date of the loan repayment, the changes in the value can generally balance each other out. According to the view of the BMF, an increase in the value of a foreign currency liability would however be presumed to be permanent, in particular, if the economic and monetary policy data had undergone a fundamental change. Such a change may be assumed if, from the balance sheet date perspective, the relations between the currency areas have changed so greatly and lastingly that it cannot be anticipated that there will easily be a return to the exchange rate recorded on the date when the liability was entered into.

In the case that involved the GmbH & Co. KG, the BFH accepted that such a fundamental change had occurred on account of the extraordinary measures taken by the Euro states to contain the European sovereign debt crisis, in 2010. It had no longer been possible to assume that, within the term of the liability, the currency fluctuations would have balanced each other out.

In the second case, the BFH likewise identified more reasons that justified a permanent value increase than indicated otherwise. As the SNB had deliberately intervened in the exchange rate development the result was a sustained change in the exchange rate and this had justified the write-up to the current value.

Please note

On the basis of this BFH ruling, taxpayers will now be able to make write-ups that reduce their tax charges irrespective of the residual time to maturity if due to a fundamental change it becomes apparent that there will be no return to the original exchange rate. Although, the taxpayer will have to bear the evidential burden for the existence of such a fundamental event.

LEGAL

RA [German lawyer] Jan-Erik Twehues

The obligation to remunerate preparatory and concluding activities in an employment relationship

So-called preparatory and concluding activities - such as, for example, time spent changing clothes, moving around the workplace, cleaning up as well as setting-up and shutting-down - have to date not generally been remunerated as working time. It is solely in the area of meat processing that there is a framework of special statutory regulations via Section 6 of the Act to Secure Workers' Rights in the Meat Industry *(Gesetz zur Sicherung von Arbeitnehmerrechten in der Fleischwirtschaft, GSA-Fleisch)* where such activities are classified as working time. Social security agencies that carry out checks are now inclined to apply Section 6 GSA-Fleisch analogously to other food processing industry sectors. This type of classification of preparatory and concluding activities as working time will however entail considerable legal problems.

1. Confirmation of previous case law on working time that requires remuneration

The courts have already had to grapple with the issue of the obligation to pay remuneration for such preparatory and concluding activities in a number of their rulings. In their decisions, the judges have linked the employer's obligation to pay remuneration under Section 611(1) of the Civil Code *(Bürgerliches Gesetzbuch, BGB)* to the performance of the promised services. According to case law, these promised services include not only the actual job but also every other activity or measure required by the employer that is directly linked to the actual job or the manner and means by which it is performed. Therefore, according to the legal rulings hitherto by the Federal Labour Court *(Bundesarbeitsgericht, BAG),* preparatory and concluding activities likewise have to be classified as


Albrecht Dürer House

working time that requires remuneration if these activities are performed within the framework of the right to issue instructions under employment law.

Against this background, in its ruling of 19.9.2012 (case reference: 5 AZR 678/11) the BAG had already decided that time spent changing clothes is included in the work that employees have undertaken to perform if the wearing of a specific type of clothing is stipulated in the contract by the employer and employees have to change their clothes in the workplace. In such a case, changing clothes primarily fulfils the needs of a third party and not your own needs since the change of clothes happens at the employer's instruction. In the ruling it was also established that, as a logical consequence, the time spent by the employee to get from the changing area to the workplace would then also have to be regarded as working time that requires remuneration. This was only recently confirmed once again by the BAG in its ruling of 31.3.2021 (case reference: 5 AZR 148/20; 5 AZR 292/20).

2. Practical significance

While the cited rulings are merely decisions in individual cases, nevertheless, it does not seem unlikely that other activities should likewise be viewed as working times that require remuneration. The remaining legal uncertainty will be borne primarily by employers who, in practice, will have to grapple with the consequences of working time that is not remunerated.

3. Consequences in the case of misjudgement

In doing so, the potential consequences for employers should on no account be disregarded. For example, the obligation to pay remuneration poses problems, in particular, in terms of social security legislation as the contribution liability is linked to the agreed remuneration. If preparatory and concluding activities constitute working time that requires remuneration then, normally, there is a risk that, besides having to subsequently pay the contributions, the competent authorities will also assume that an offence has been committed.

Recommendation: Employers can help to prevent these problems by making individual contractual arrangements with their employees. Generally, it is possible to make a separate remuneration rule for an activity other than the actual job, or this obligation to pay remuneration can be completely waived via a provision in the employment contract or a collective agreement.

IN BRIEF

Unconstitutionality of excessive interest on tax arrears/refunds – consequences from the tax administration

In July 2021, the Federal Constitutional Court *(Bundesverfassungsgericht, BVerfG)* classified the statutory interest on tax arrears and tax refunds of 6% per year as unconstitutional as of 2014. Accordingly, the local tax offices may only continue to apply the 6% rate for interest periods up to and including 31.12.2018. For the subsequent interest periods, the BVerfG has committed the legislative body to come up with a new regulation that is compatible with the constitution. Lower Saxony's State Office for Taxes *(Landesamt für Steuern Niedersachsen, LStN)* expressed its view on the ruling in September already (recently confirmed in a circular of 29.11.2021 by the Federal Ministry of Finance *(Bundesministerium der Finanzen, BMF).*

According to this, the BVerfG ruling only affects interest on tax arrears and tax refunds and not however interest relating to tax deferrals, tax evasion, tax suspension and interest during pendency of legal action. That is why the local tax offices will once again immediately reject any applications filed because of the unconstitutionality of such interest. Ultimately, this interest will have to be paid by the taxpayer. Assessment notices for interest for the period up to 31.12.2018 that, up to now, were still provisional on account of the pending BVerfG ruling, will now have to be regarded as being final. Amounts that had been suspended up to now will have to be paid. The local tax offices are currently no longer allowed to require 'new' interest payments for the period starting from 2019; instead, they will have to wait and see what new rules the legislator will make on the interest chargeable on subsequent tax payments. The Bundestag [lower house of German parliament] and Bundesrat [upper house of the German parliament] have until 31.7.2022 to do this. They can also bring the new rules into force with retroactive effect starting from 2019. Final assessment notices for the

Miniatures of typical Nuremberg houses at the main Nuremberg Christmas Market

interest payable that cannot be amended any more for periods starting from 2019 will generally not be affected by this because of the so-called administrative finality of such assessment notices.

According to the guidelines from the LStN, until such time as the new rules have been put in place, for the period from 2019, local tax offices should proceed as follows with provisional effect:

(1) Assessment notices, which have to be newly issued, for the setting of interest on arrears or refunds for the first time will, from the outset, be provisionally set 'to zero' with respect to this interest until the legislator has created a replacement regulation and the local tax office can then apply this to the cases (if necessary, retroactively).

(2) Assessment notices that were issued prior to the BVerfG ruling and which are provisional will generally continue to remain provisional so long as none of the involved parties 'touch' them. As soon as the legislator has made the replacement regulation, the local tax offices will make these changes autonomously on their own initiative and, generally, without any further 'pushing' on the part of the taxpayer.

(3) In the case of assessment notices that were issued prior to the BVerfG ruling and now - for whatever reason - have to be amended, what matters here is whether the amendment will result in a subsequent payment or a refund for the taxpayer. In the case of a subsequent payment, the local tax office will provisionally set any further amount of interest in this respect 'to zero' (as in the case of new notices of assessment). In the case of a refund, the local tax office will reimburse interest, too, insofar as it was overpaid.

Please note: On this topic, please see also the ruling of general application by the Länder [Federal States] of 29.11.2021; we were unable to go into detail about this because of the copy deadline for this newsletter. This ruling confirms the differentiated approach, described above, for assessment notices for interest up to 31.12.2018 or from 2019 onwards.

Accruals have to be recognised in the balance sheet even in the case of small amounts

The Federal Fiscal Court *(Bundesfinanzhof, BFH)* recently issued a ruling where it decided that, for allocations under the accrual method, businesses that prepare accounts have to create accrual adjusting entries irrespective of the amount, therefore, without making an exception for small amounts.

Generally, an accrual adjusting entry for pre-paid expenses has to be created if the expenses were incurred before the reporting date but only have to be recorded after this date as expenses that reduce income. In this way, the profit-reducing effect is shifted into the next period. Conversely, an accrual adjusting entry for deferred income has to be created if a company receives a payment that is only supposed to have the effect of raising income in a subsequent period.

The BFH dealt with the issue of appropriate accrual adjusting entries in its ruling of 16.3.2021 (case reference: X R 34/19). A businessperson had recorded many small amounts directly as operating costs in the year that the amounts had been paid; these expenses had included payments for liability insurance, advertising and motor vehicle tax. The individual items taken together totalled between €1,315 and €1,550 per year. The local tax office took the view that these pre-paid small amounts should also be accounted for via an accrual adjusting entry for pre-paid expenses so that there would be an increase in income.

In the first instance, the Baden-Wuerttemberg tax court decided that in view of the negligible importance of the costs no accrual adjusting entries needed to be created. The court had been guided here by the value limit of € 410 that was applicable at that time for the instant write-off of low-cost assets (currently this is a net amount of € 800). In the second instance, however, the BFH disagreed with this position and ruled that the local tax office had rightly called for an accrual adjusting entry for pre-paid expenses to be created.

Please note: Under the German Income Tax Act the capitalisation of the respective costs is generally mandatory - there is no option. Since the requirement to create accrual adjusting entries is not limited to significant cases there is a lack of a legal basis for expenses of negligible importance to allow the assumption that there is an option to create an accrual adjusting entry for pre-paid expenses.

AND FINALLY...

“What we’re actually talking about here is peanuts.”

Hilmar Kopper, 13.3.1935 – 11.11.2021, was a German bank manager and, from 1989 to 1997 Chairman of the Board of Deutsche Bank. In 1994, he used the word “peanuts” to describe losses of some DM 50m generated by the property fraudster Schneider. He was strongly criticised for this statement at that time - even though in view of the events that took place in subsequent years he was proved to be right.

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