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Tax Law / Corporate

Tax Consequences of the Modernization of the German Accounting Principles through BilMoG

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The main objective of the Bill on the Modernization of the German Accounting Law (*Bilanzrechtsmodernisierungsgesetz = BilMoG*), which became effective on 29 May 2009, is to increase the attractiveness of the German accounting principles in comparison to the International Financial Reporting Standards (IFRS) by way of modernizing the German Commercial Code (*Handelsgesetzbuch*) and thereby modestly bring its provisions closer to the IFRS. The changes adopted by BilMoG are mandatorily applicable for fiscal years beginning in 2010. On a voluntary basis, companies may already apply the provisions for fiscal years beginning in calendar year 2009. BilMoG basically aims at tax neutrality. However, legislator has allowed exceptions in this regard. Moreover, the changes according to BilMoG may have an impact on the taxable income in case the tax consequences are directly linked to the commercial balance sheet. The following presentation sets out an overview of significant tax consequences of BilMoG.

1. One Balance Sheet for Commercial and Tax Purposes (*Einheitsbilanz*) – still possible?

The principle that tax accounting shall be based on commercial accounting (*Maßgeblichkeitsgrundsatz*) will basically still apply after BilMoG takes effect. The legislator's idea behind such principle is to enable small and medium-sized enterprises to prepare one balance sheet for commercial and tax purposes. However, it seems reasonably doubtful whether this will still be possible after BilMoG. Rather, due to the abandonment of the „reverse“ principle that tax accounting shall also be authoritative for commercial accounting (*umgekehrte Maßgeblichkeit*; see below lit. a) and the fact that various changes of the commercial accounting principles are not also adopted for tax balance sheet purposes (see below lit. b.), in practice the companies might no longer be in a position in the future to prepare “only” one balance sheet for both commercial and tax purposes.

a. Abandonment of the Principle that Tax Accounting shall be authoritative for Commercial Accounting (*umgekehrte Maßgeblichkeit*)

So far, options granted by German tax law for the determination of taxable income have to be exercised in accordance with the commercial balance sheet. Correspondingly, according to the law as currently in effect, both special reserves which are permissible for tax purposes as well as special tax depreciations may also be included in the commercial balance sheet.

However, BilMoG will abandon the principle that the tax balance sheet is also authoritative for the commercial balance sheet. Thus, liabilities like the so-called “untaxed special reserves” (*Sonderposten mit Rücklageanteil*), which are permissible for tax purposes, can no longer be recognized in the commercial balance sheet. Likewise, special tax depreciations such as the transfer of hidden reserves



realized in the sale of real property according to sec. 6 b Income Tax Act (*EStG*) may no longer be included in the commercial balance sheet.

b. Change of Accounting Provisions which concern only the Commercial Balance Sheet

Since BilMoG shall basically have no effect on taxable income (tax neutrality), various changes concerning the inclusion and valuation of assets in the commercial balance sheet will not also be adopted for tax purposes and, therefore, result in a deviation of the commercial from the tax balance sheet. This shall, inter alia, apply in the following cases:

- Capitalization of internally created intangible assets (e.g. goodwill, software): BilMoG introduces an option to capitalize these assets in the commercial balance sheet, whereas no such capitalization is allowed in the tax balance sheet.
- Offset of pension liabilities with assets which may only be used to satisfy such liabilities (so-called „plan assets“): According to BilMoG, an offset shall be made in the commercial balance sheet, whereas no such offset is permissible for tax purposes.

Important Note

In the event a taxpayer intends to exercise an option granted by German tax law in a way that would result in a future deviation of the tax balance sheet from the commercial balance sheet (due to the abandonment of the principle that tax accounting shall be authoritative for commercial accounting), such taxpayer has to implement a so-called documentation bookkeeping (*Nachweisbuchführung*). In this case, assets which are not accounted for in the same way in the commercial and the tax balance sheet would have to be included in specific, ongoing lists, which display the date of acquisition/production of the asset, its acquisition/production costs, the specific option right which has been exercised as well as the amount of depreciation which has been claimed so far.

2. Deferred Income Taxes

Active and passive deferred income taxes shall display the deviation of the effective income tax liability of a taxpayer (based on the taxpayer's taxable income which has been determined on the basis of the tax balance sheet) from its "virtual"

income tax expense as determined according to the commercial balance sheet. Deferred income taxes result from differences in provisions covering the inclusion and valuation of assets and liabilities for tax purposes on the one hand and for commercial purposes on the other hand. Due to the various differences introduced by BilMoG (cf. no. 1), deferred income taxes may become more relevant in the future.

Henceforth, deferred income taxes will be determined by using the so-called temporary-concept, which focuses on the book values of the balance sheet items and, therefore, requires a comparison of the commercial balance sheet with the tax balance sheet with respect to each single balance sheet item.

In case the effective tax liability determined in accordance with the Corporation or Income Tax Act is lower than the income tax expense according to the German Commercial Code, and this deviation is caused by differences in the inclusion and/or evaluation of balance sheet items which will be compensated in the following years, passive deferred income taxes have to be accounted for in the commercial balance sheet.

In the reverse case that the effective tax liability exceeds the income tax expense, BilMoG grants an option to capitalize active deferred income taxes. In case the taxpayer is included in consolidated financial statements of a group, active deferred income taxes have to be capitalized. When determining active deferred income taxes, tax loss carry-forwards have to be taken into account to the extent their offset with future taxable income can be expected within the following five years.

Important Note

Since for purposes of determining deferred income taxes the commercial and tax balance sheet will have to be compared with respect to each single item, in the future the tax balance sheet will often have to be prepared contemporaneously with the commercial balance sheet, and no longer in connection with the preparation of the tax return. This is particularly true in case the examination of the prospective offset-potential of tax loss carry-forwards is required.

3. Tax Deductibility of Interest Expense (Interest Ceiling Rules = *Zinsschranke*)

Since the business tax reform (*Unternehmensteuerreform*) has become effective, the tax deductibility of interest expenses can be restricted by the so-called interest ceiling rules. According to these provisions, the excess of interest expenses over interest income (net interest expense = *Zinssaldo*) of a taxpayer is basically only deductible to the extent of 30% of the so-called EBITDA (= tax profits less interest income plus interest expenses and plus claimed depreciations). Thus, the interest ceiling rules may particularly apply – and impose an additional financial burden on taxpayers due to the non-deductibility of effectively accrued interest expense – in difficult economic times, in which low or even no profit can be generated and, therefore, the 30%-EBITDA-threshold is very low.

One of the – very limited – exceptions to the interest ceiling rules (resulting again in the full deductibility of the interest expense) applies in case the taxable entity (= *Betrieb*) is part of a consolidated group and the equity ratio of such entity is not lower than the equity ratio of the consolidated group (so-called escape-clause).

Said equity ratio is basically determined according to the proportion of the equity to the balance sheet total as shown in the annual financial statements (single entity) and the consolidated financial statements, respectively. Those underlying financial statements may be prepared in accordance with the German Commercial Code, unless there exists an obligation that the consolidated financial statements have to be prepared in accordance with IFRS, or within the last five years IFRS-consolidated financial statements have been prepared on a voluntary basis.

Thus, in case the relevant financial statements are prepared according to the German Commercial Code, the changes made by BilMoG that affect the equity ratio of a business may have taxable consequences:

- In case assets which have so far not been included in the balance sheet are now capitalized according to BilMoG, the equity and, therefore, the equity ratio of the business will increase. In case this leads to the applicability of the escape-clause, the capitalization would have tax advantages due to the avoidance of

the interest ceiling rules. This could be relevant in case of internally generated intangible assets and active deferred income taxes, for which an option for capitalization is now introduced (see above).

- If according to BilMoG liabilities have now either to be newly recognized or to be accounted for at a higher value than prior to BilMoG, the equity/equity ratio will be reduced. This may result in tax disadvantages if the interest ceiling rules do apply due to the inapplicability of the escape-clause.

Important Note

If or to the extent, respectively, an option for capitalizing of assets in the commercial balance sheet is available in the future, not only accounting policy aspects, but also potential tax aspects should be taken into account.

4. Financial Instruments acquired for Trading Purposes

Henceforth, financial instruments acquired for trading purposes (e.g. shares, derivatives, bonds) have to be valued at fair market value less a deduction to account for risks (*Risikoabschlag*) in both the commercial and tax balance sheet, if the financial instruments are held by credit institutions or financial services institutions for trading. For all other companies, no such valuation applies (in contrast to the initial intentions of legislator).

Fair market value is the market price, if an active market exists for the financial instruments. Otherwise, commonly accepted valuation methods have to be applied. Accordingly, if the fair market value is higher than the original acquisition costs of the financial instruments, the recognition at fair market value results in the taxation of „only“ realizable but not yet realized income.

Important Note

In case the first-time valuation of the financial instruments held/acquired for trading at fair market value results in taxable gain, „only“ one half of this gain has to be taxed in the respective fiscal year. The taxation of the other half may be deferred to the subsequent fiscal year by way of recognizing a corresponding reserve.

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