

Reporting by Corporations as part of German Compliance Requirements - Synopsis

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A. Introduction

Corporate reporting as an aspect of German compliance is not limited to tax reporting but rather also includes accounting compliance aspects.

The importance of compliance for corporations as a means of avoiding criminal charges and liability as well as for improving a company's reputation is currently increasing among managers of German companies. Furthermore, throughout German legal literature, compliance-systems are regarded as mandatory for major corporations¹ wishing to avoid various disadvantages and future court decisions are expected to agree with this opinion.

This development was partially influenced by an amendment to Sec. 107 (3) 2 of the German Stock Corporation Act (*Aktiengesetz*, AktG) which was introduced by the Modernisation of Accounting Law Act (*Bilanzrechtsmodernisierungsgesetz*, or BilMoG) in 2009. The revised Sec 107 (3) 2 AktG explicitly states that supervisory board members can be held personally liable for a corporation's failure to comply with accounting and annual return regulations to the extent that they do not properly monitor the corporation's respective compliance systems. Members of the supervisory board who neglect these duties can be held liable for any damages resulting from such neglect².

This provision thereby widens the circle of persons who are potentially liable for a corporation's failure to meet its reporting obligations to include the supervisory board members in addition to the corporation itself and its managers. Given the potential liability to all individuals involved, meeting reporting obligations under accounting and tax laws are an increasingly important part of corporate compliance.

B. Accounting Compliance

1. German Accounting Principles

German accounts must be prepared in accordance with the German accounting standards set forth by the German Commercial Code (*Handelsgesetzbuch*, or HGB) as well as other accounting standards recognized by German law (e.g. IFRS).

German accounting standards are generally governed by the principles of truthful accounting (*Bilanzwahrheit*); clear accounting (*Bilanzklarheit*) and prudence (*Vorsichtsprinzip*) and have the general purpose of safeguarding the interests of potential business partners and creditors.

Peter H. Dehnen
Rechtsanwalt
Fachanwalt für Steuerrecht
S.L.C. (Washington, D.C.)

Prinz-Georg-Straße 91
D-40479 Düsseldorf

☎ +49 (0)211 44 97 07
☎ +49 (0)211 44 97 722
✉ peter.dehnen@dehnen.de

www.dehnen.de

¹ Hauschka, Corporate Compliance (*Handbuch der Haftungsvermeidung im Unternehmen*) 2010, § 1, Rz. 10.

² Sec. 116 (1), 93 (2) AktG.

The type and number of accounts which German companies must prepare depends on a company size and, to some extent, legal form. Share corporations (*Aktiengesellschaften* or AGs) which are publicly traded, for example, have more extensive reporting obligations than smaller, privately held companies. In general, German accounting law distinguishes between small, medium and large companies with the determination based on the following three criteria

- Total amount of balance sheet assets;
- Total annual turnover; and
- Average annual number of employees

The classification is based on a determination of whether the following thresholds are exceeded over a period of two fiscal years:

	Total Assets	Turnover	Employees
Medium	EUR 4,840,000	EUR 9,680,000	50
Large	EUR 19,250,000	EUR 38,500,000	250

A number of special rules exist in addition to these criteria, such as, for example, the classification of all publicly traded companies as large corporations with the resulting reporting duties.

Small corporations (those which do not exceed the thresholds of a medium-sized company) are required to prepare:

- Annual financial statements comprising a balance sheet and profit and loss statement;
- Accompanying notes explaining the various account positions.

If a corporation exceeds the above-mentioned thresholds and is thereby classified as a medium-sized or large corporation, it is obligated to prepare the following reports and accounts:

- Audited annual financial accounts (balance sheet + profit and loss statement with accompanying notes);
- Management report regarding the status of the company;
- Supervisory board report (only AGs);
- Proposal/ decision regarding distribution of profits
- Compliance statement under the German Corporate Governance Code (only AGs)³.

While the distinction between medium and large companies is not important for the determination of which accounts must be prepared, medium-sized companies are subject to somewhat lower obligations in the actual preparation of the accounts.

In general, all corporations are required to publish the required annual accounts within 12 months following the end of the relevant fiscal year.

³ Sec. 325 HGB

2. German Audit Regulations

Medium-sized and large companies must subject their annual financial statements to review by an independent auditor who must verify that the accounts were prepared in accordance with applicable accounting rules.

Additionally, publicly held companies, the shares of which are traded on German stock exchanges, are subject to review under a two-stage enforcement system introduced by the Accounting Control Act of 2004 (*Bilanzkontrollgesetz*, or BilKoG). The first stage is carried out by the Financial Reporting Enforcement Panel (FREP), a government-appointed, but private institution⁴, while the second stage is performed by the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, or BaFin).

Generally, the FREP initiates an examination

- if there are concrete indications of an infringement of financial reporting requirements (examination with cause);
- at the request of BaFin, when certain indications exist, or
- without any concrete indications based on random sampling (random sampling examination).

In such a review, the FREP's duty is to determine whether the most recent financial reports published by the company under review were prepared in accordance with the accounting principles and regulations applicable to the company, including the accounting standards imposed by law.

Since the FREP is a private organization, it can only conduct examinations with the consent of the company under review. If the company agrees to review by the FREP, its legal representatives are obliged to provide accurate and complete information and to submit accurate and complete documents. Failure to do so can result in fines of up to EUR 50,000.⁵ If the company rejects FREP review, the FREP must notify BaFin which, under its discretionary authority, may order a second-stage examination which it conducts directly.

If the FREP determines that an error exists in the financial reports of the company under review and the company agrees with such determination, the BaFin is informed which then can order the company to publish a correction of its financial reports together with the reasons supporting the determination. If the company does not agree with the FREP's findings, the determination is reviewed by the BaFin. If the BaFin agrees with the FREP, the company can still pursue other legal measures to challenge the determination.

In 2009, the FREP conducted a total of 118 examinations, in around 20 % of which it found errors.⁶

⁴ Sec. 342b HGB

⁵ Sec. 342e HGB

⁶ FREP 2009 Annual Activity Report, p. 2

3. Recent Accounting Developments

The Modernisation of Accounting Law Act (*Bilanzrechtsmodernisierungsgesetz*, or BilMoG 2009) was intended to conform German accounting standards to international standards. The measures enacted by the BilMoG resulted in the most comprehensive amendment of German accounting law in the last 20 years even though, due to the worldwide economic crisis, various aspects were eliminated from the final law.

The amendments which were adopted were intended to ease accounting rules for small and medium-sized businesses as well as to introduce valuation methods which better represent a company's actual business value. The following are some of the more important changes:

- The initial accounting threshold has been raised so that established merchants are now first obligated to prepare commercial financial statements when business turnover exceeds EUR 500,000 or business profits exceed EUR 50,000;
- Interim thresholds, which require companies to prepare different types of financial statements depending on their size, have also been increased by 20 %;
- When valuing liability reserves, interest discounting as well as price and cost increases may be taken into account;
- Several commercial accounting options, such as the write-off of future value fluctuations, were abolished; and
- The “reverse principle of correlation” was adopted with the result that commercial balance sheets must now be adjusted to reflect changes in the tax balance sheet created by the abolishment of the options discussed above.

4. Publication of Annual Accounts

Prior to 2007, privately held corporations were only obligated to disclose annual accounts to the local court (*Amtsgericht*). Since breaches of the reporting duty were generally not subject to legal sanctions, accounts were only disclosed by a small proportion of the affected corporations.

Since 2007, when the *Act on the Electronic Commercial Register, the Register of Cooperatives and the Company Register (Gesetz über elektronische Handelsregister und Genossenschaftsregister sowie das Unternehmensregister*, hereinafter “EHUG”) was passed, publication of annual financial statements must be done through the Electronic Federal Gazette⁷, the operator of which is authorized to review whether registered companies fulfill the disclosure obligations set forth by the HGB. If the operator determines that the required information has not been disclosed, it informs the Federal Office of Justice (*Bundesamt für Justiz*, BfJ)⁸, which then gives the affected corporation 6 weeks to

⁷ Sec. 325 HGB

⁸ Sec. 329 HGB

provide the necessary information under threat of penalty.⁹ Further failure to publish the required accounts then results in a penalty of EUR 2,500 to EUR 25,000¹⁰.

The obligations of the EHUG were applied retroactively to fiscal years starting after 31 December 2005 and the first proceedings against non-compliant corporations were started in 2008. While in 2008, 460,000 cases were pursued by the Federal Office of Justice, in 2009 that number had fallen to 120,000 cases which shows that companies are taking the new disclosure requirements seriously.

5. Legal Consequences and Effects of Accounting Regulations

Not only does the EHUG require disclosure in the Electronic Federal Gazette, it also requires publication of annual accounts in the Electronic Commercial, Cooperative and Company Register and allows public access to such information through the homepage of the Electronic Company Register¹¹. Any information provided to the Electronic Federal Gazette is therefore publicly accessible to any person¹².

While access to such data was already possible before enactment of the EHUG, it was quite limited due to the fact that only a small number of companies actually published information as well as the inconvenience of sending a written request to the respective local court.

The combination of mandatory reporting together with the quick and easy public access created by the EHUG makes it more likely for a corporation's sensitive business and trade information to become public knowledge and potentially subject the company to increased industrial espionage. A case challenging the EHUG's disclosure obligations is currently pending at the German Federal Constitutional Court with the plaintiff, a German GmbH, claiming that the EHUG violates its right of self-determination in the publication of its information (*Recht auf informationelle Selbstbestimmung*).

C. Tax Compliance

1. General Reporting Obligations under German tax law

Under German law, tax authorities are obligated to investigate the facts necessary for determining the existence and extent of a taxpayer's tax burden.¹³ While the tax authorities must determine the facts of a case, the taxpayer must cooperate with such investigation, for example by filing a tax return as required by German law.

In addition to annual income tax returns, corporations are also required to file monthly or quarterly preliminary VAT returns (depending on their level of income) as well as an annual VAT return. Annual returns must generally be filed by 31 May of the calendar year following the relevant

⁹ Sec. 335(2) – (6) HGB.

¹⁰ Sec. 335 (1) 4 HGB.

¹¹ <https://www.unternehmensregister.de/ureg/>.

¹² Sec. 9 HGB.

¹³ Sec. 88 Federal Fiscal Act (*Abgabenordnung*, or AO).

fiscal year. Preliminary VAT returns must generally be filed by the 10th day of the month following the period covered by the return. Where professional advisers prepare the tax return, the due date is generally extended to 30 September and filing dates may also be extended upon request of the taxpayer¹⁴. Generally, all tax returns are filed electronically¹⁵ and all returns are reviewed by the tax authorities. Furthermore, the taxpayer has the duty to disclose any errors which may have occurred within a tax statement and correct them as soon as possible after discovery by the taxpayer¹⁶.

While the duty of cooperation is generally limited to providing correct and complete information regarding the facts relevant for taxation as well as supporting documentation¹⁷, in certain situations the taxpayer's duty to cooperate is increased. The two most important areas of increased cooperation are transactions with cross-border aspects and audits by the tax authorities.

a. Cross-border Transactions

Where taxation involves cross-border transactions, a taxpayer must not only set forth the facts of a case but also provide necessary evidence in support of such facts¹⁸. In this regard, the taxpayer must exhaust all existing factual and legal possibilities for providing such evidence. This increased obligation on taxpayers in regard to cross-border matters arises from the limited right of the German tax authorities to investigate tax matters relating to foreign countries unless such investigation is allowed by double taxation conventions (DTCs) or tax information exchange agreements (TIEAs). In cross-border situations, all information regarding foreign countries is regarded as being within the taxpayer's sphere of influence rather than within the reach of the German tax authorities. This assumption particularly applies to business relations between related companies in which case documentation and disclosure of evidence is mandatory in order for the taxpayer to be granted tax benefits such as the deduction of business expenses paid to related companies.

A recently enacted *Act to Combat Destructive Tax Practices and Tax Fraud* extends these obligations to dealings with persons in those foreign countries which are specified by the German Finance Ministry as not in compliance with OECD transparency standards and exchange of information requirements (tax havens). The act imposes increased documentation and verification obligations in regard to such business relationships while denying the tax exemption of inter-company dividends and the deduction of business expenses related to such transactions. While this law has entered into force it currently has no effect since the German Finance Ministry has not named any countries which do not meet the specified standards.

¹⁴ Sec. 109 AO.

¹⁵ Sec. 150 (6) AO.

¹⁶ Sec. 153 AO.

¹⁷ Sec. 90 (1) AO.

¹⁸ Sec. 90 (2) AO.

The increased duty of a taxpayer to cooperate and provide information is not, however, unlimited but rather ends where the cooperation asked by tax authorities is of no relevance for German taxation¹⁹. This could, for example, be the case if the tax authorities request information relating to the taxation of persons or companies who are not subject to German taxation.

b. Tax Audits

The German tax authorities are authorized and, in some cases required, to conduct tax audits in regard to taxpayers who engage in commercial or freelance work or other taxpayers whose annual income exceeds EUR 500,000. In general, local tax authorities are competent in regard to tax audits and are given discretion as to the taxpayers, the type of taxes, the circumstances and the time frames to be audited. However, the Ministry of Finance, in the Tax Audit Regulations (*Betriebsprüfungsordnung* or BpO) has issued administrative regulations as to how such discretion must be exercised.

Large companies, for example, must be audited regularly and without excluding any fiscal years²⁰. The practice in this regard over the last few decades has been to audit large companies every three years. For other companies, no special audit terms are specified.

Taxpayers have an increased duty of cooperation in regard to tax audits in that a taxpayer's representatives must assist the auditor in assessing the facts necessary for the determination of taxation. The main duties of cooperation in tax audits are the presentation of any business documents as well as the disclosure of circumstances which are relevant for the taxation determination.

An auditor cannot, however, require information which a taxpayer is not obligated by law to provide or which is not relevant to the taxation determination. These limits also extend to any electronically stored information to which the examiner might request access.

2. Consequences of Late, Incomplete or Incorrect Reporting

German courts have held that the German tax authorities must believe the statements made by the taxpayer unless justified doubts²¹ exist in regard to such facts, including, for example, doubts arising from a taxpayer's non-compliance with its duty to provide information²².

The main consequence of non-compliance with the obligation to provide information is refusal by the tax authorities to allow deduction of expenses claimed by the taxpayer²³. The tax authorities may refuse such deduction, for example, if the taxpayer fails to name the recipient of

¹⁹ Fiscal Court Niedersachsen, decision of 10. January 2008, 6K 63/06, published in Decisions of Fiscal Courts (*Entscheidungen der Finanzgerichte*, or EFG) 2008, 772.

²⁰ Sec. 4 (2) BpO.

²¹ Official Tax Gazette (*Bundessteuerblatt*, or BStBl) II 1986 p. 241.

²² Federal Fiscal Court (*Bundesfinanzhof*, or BFH) 10 July 1996, I R 4/96, BStBl. II 1997, 15.

²³ Sec. 160 AO.

the expenses when asked by the tax authorities. Such information is used by the German tax authorities for issuing so-called control notices (*Kontrollmitteilung*) which ensure that the recipient declares as income the amounts received from the paying taxpayer. In cases involving a foreign recipient, the taxpayer must inform itself regarding the recipient person or company. If the named recipient is, or is regarded by the German tax authorities, as a shell corporation, the taxpayer's obligation to name the recipient is increased to determining and naming the final beneficiary of the payments which the taxpayer claims as deductions.

If a taxpayer refuses to cooperate and, as a result, the factual investigation fails due to insufficient information, the tax authority is entitled to estimate the tax base.²⁴ Furthermore, German tax authorities may compel fulfillment of the taxpayer's duty to cooperate by imposing late-payment fines or compulsory levies.²⁵

A taxpayer's breach of the duty to cooperate which results in tax evasion may constitute a tax crime or misdemeanor²⁶ in which case the tax authority can initiate criminal or penalty proceedings against the taxpayer.

3. Recent Developments

The German tax climate used to be one of cooperation in which local tax authorities were willing to discuss issues with taxpayers in order to find mutually acceptable solutions to various domestic and cross-border tax issues. Over the past few years, however, an increasingly adversarial tax environment has arisen in Germany. This change in the German tax climate together with constant amendments to existing laws have resulted in increasing uncertainty in tax planning and an increased use of litigation as a means for ensuring a correct and fair application of Germany's tax laws.

Furthermore, tightening criminal tax laws as well as the denial of tax relief increase the need to implement proper tax compliance systems which ensure that all relevant and necessary information is made available to the tax authorities. Liability for mistakes or breaches of the duty to cooperate, including providing sufficient documentation, can arise not only for the company itself but also for its legal or tax advisor as well as the company's representatives who may be subject to personal liability.

The increasing scope and complexity of German Tax law and, in particular, the impact of the German legislative process on reporting obligations can be illustrated through the example of two regulations (*Zinsschranke* and *Mantelkauf*) introduced by the German Business Tax Reform of 2008. These regulations were intended to combat the misuse of tax saving possibilities under German tax law and require the taxpayer to prove that certain prerequisites are met in order to, for example, deduct interest payments (*Zinsschranke*) or utilize the loss carry forwards of acquired companies (*Mantelkauf*). While these

²⁴ Sec. 162 AO

²⁵ Sec. 328 ff. AO

²⁶ Sec. 370 AO, Sec. 378 AO

provisions were somewhat eased by the Act for the Acceleration of Economic Growth passed in 2009 due to the worldwide financial crisis, this was achieved at the expense of increased obligations on taxpayers to prove the fulfilment of the imposed prerequisites.

The denial of deductions for business expenses or loss carry-forwards unless certain prerequisites are met increases the taxpayer's obligation to provide information – not only must the taxpayer prove that the expenses were incurred in the course of its business or the accuracy of the loss carry-forwards, it must also show that the conditions imposed by law for application of the provisions are met.

D. Summary

Reporting obligations under German corporate compliance are important both in terms of accounting compliance as well as tax compliance.

One main aspect within German accounting compliance is the disclosure obligations to the Electronic Federal Gazette. Since information disclosure is intended to protect third parties by informing them as to the financial situation of a corporation, failure to comply with the revised reporting obligations can result not only in possible penalty charges for non-disclosure but also in potential liability for losses to third parties resulting from insufficient or incorrect disclosure.

In regard to German tax compliance, there seems to be, in addition to a cut-back of tax deductions, a tendency toward a greater burden of cooperation and proof on taxpayers in order to be granted the tax reliefs provided by law accompanied by an increasing unwillingness of the German tax authorities to work with taxpayers to find mutually acceptable solutions to tax issues.