Rödl & Partner

M&A DIALOGUE

LEGAL, TAX, FINANCIAL NEWS

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Articles in this issue

→ Freelance and false self-employed persons

The use of freelance workers continues to be a very popular option. For this reason, when working on a company transaction, the information and documents received about freelance workers need to be checked in detail so that the purchaser can better assess the risk of possible false self-employment.

FREELANCERS

Freelancers are independent workers who provide services to a third party under a service or work contract, without being employed by the third party. As a result, freelancers must be distinguished from employees.

A freelance relationship differs from an employment relationship, in particular in the degree of personal freedom. An employee is a person who is integrated into the activities of a third party, his employer, and to whom the employer has a comprehensive right to issue instructions in relation to the timing, duration, location and type of work to be executed. In contrast to this, freelancers can freely determine their activities and working hours.

FALSE SELF-EMPLOYED PEOPLE

Since a clear distinction is not usually so easy, both freelancers and those who use them are often unaware of the real status. The stronger the principal's instructions that the services must be performed personally and/or the more tightly the person concerned is bound into the principal's organisation, the more likely it is that an employment relationship actually exists, resulting in a situation of false self-employment.

CONSEQUENCES OF FALSE SELF-EMPLOYMENT

A false self-employment relationship means that social security contributions and payroll taxes must be paid.

The question of status as to whether someone is an employee as defined by social security law, can be clarified by means of a status determination procedure by the clearing office of the Deutsche Rentenversicherung Bund (German pension insurance federation). If a false self-employed status is determined, the obligation to pay social security contributions generally applies from the start of the work activity. If the work activity was started a long time ago, there is a risk that the unpaid employer and employee social security contributions will have to be paid retrospectively for up to four years, based on the results of the status determination procedure, and if there was deliberate evasion, for up to as many as 30 years. In this case, the employer can claim back from the employee the share of the total social security contribution normally borne by the employee, but this claim must on the one hand be executed by a deduction from the remuneration and, on the other hand, may only be collected from the next three payslips. While doing this, the attachment-exempt threshold must also be observed. For this reason, the employer will remain liable for the majority of the retrospective contributions due. In addition, an interest charge can be expected. The determination of false self-employment also has consequences under tax law, because the employer has a duty to withhold income tax due on a salary and to pay it to the tax office. In addition to the employer, the employee himself is liable to pay income tax. The tax office has to decide, after due consideration, from whom to collect this. The tax office can demand retrospective payment for up to four years in the case of false self-employment. In the case of reckless (unintentional) tax evasion, this period can be extended to five years. If the false self-employed status was intentionally created, there may even be a case of deliberate tax evasion. However, the topic of false self-employment does not stop at financial risks, but can also involve criminal risks such as fines or imprisonment for the management. The risk of discovery also exists in the event of a tax audit should no status determination procedure be carried out.

THE MAIN INDICATIONS OF LIKELY FALSE SELF-EMPLOYMENT ARE:

- Set working hours and locations
- Integration into the third party's company

- Free use of equipment belonging to the third party
- Personal performance requirement
- Compensation for vacation and sickness days
- Absence of any entrepreneurial risk

CONCLUSION

The documentation and information about free-lancers must always be checked carefully, so that after the company transaction is concluded, there are no unexpected additional costs and liabilities lying in wait due to false self-employment.

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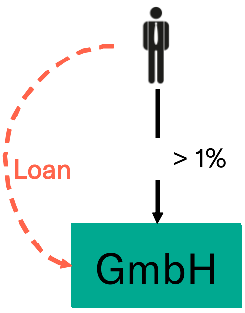
→ Receivables defaults from a shareholder loan

The granting of a loan by a shareholder to “his” company is common practice. Special circumstances must be taken into account due to the special relationship under company law. If the debtor finds him- or herself in a financial crisis, the repayment of his shareholder loan is frequently rendered impossible due to the liquidation or sale of the company.



The tax treatment of a loan loss for shareholders who have maintained their **holding in a stock corporation as part of their private assets within in the meaning of Section 17 EStG (Income Tax Act)** (holding of 1 percent or more within the last five years), has been subject to many changes over the last three years. Due to the ongoing “ping-pong” between case law (most recently the decision of the Düsseldorf Fiscal Court on 28/01/2020) and the tax authorities as well as changes in the tax legislation, there are now several competing regulations. This article aims to provide an overview.

NEW CASE LAW: APPLICABLE SINCE 27/09/2017

With the landmark decision of the Federal Fiscal Court (BFH) on 11/07/2017, a deviation was made for the first time from the previous tax treatment of a loan loss. The new case law applies from 27/09/2017 onwards. In the opinion of the tax authorities, in all other open cases, for reasons of protection of legitimate expectations, it is possible to continue to apply the previous case law and the approach of the tax authorities concerning equity-replacing financial support or debts.

I. Tax treatment before 27/09/2017:

In the case of a shareholder loan, under the case law prior to the latest change in case law and in the opinion of the tax authorities, the final **default of capital claims** should be regarded as **subsequent acquisition costs.** Up to 60 percent of the loan loss resulting from the default can generally be used in the context of what is known as the *Teileinkünfteverfahren* or partial income procedure. In this case, the loss can only be considered for tax purposes at the time of the sale or liquidation of the company. In order to be considered as subsequent acquisition costs, the loan must have been granted as a result of the company relationship. This is regularly the case if, at the time the loan was granted or continued to be granted, the repayment of the loan was at risk in view of the financial situation of the company to such an extent that a prudent businessman would no longer have taken the risk of granting a loan on the same terms as did the shareholder.

II. Tax treatment after 27/09/2017:

With the change in case law, the expense of granting a loan may also represent a **loss of income from capital assets.**

The BFH justified its decision based on the cancellation of the equity substitution rights under the “Law for the Modernisation of the German Limited Liability Company Law and the Prevention of Misuse” (MoMiG) in 2008. According to this, an approach based on Commercial Law is to be followed when classifying the loan loss as a subsequent acquisition cost. In principle, only such expenses of the shareholder can represent subsequent acquisition costs of the participation which, in accordance with the principles of commercial and tax accounting law, inversely lead to an open or hidden contribution to the company’s capital. This includes, in particular, waiving a recoverable amount of receivables. Conversely, the default of a non-recoverable claim does not represent any subsequent acquisition cost, as this does not lead to a capital contribution to the company. The case is rather different if the loan provided by the shareholder, due to the contractual agreements, is equivalent to providing a contribution to the company’s assets. This is the case, for example, with a shareholder loan with a subordination agreement within the meaning of Section 5 Para. 2a EStG.
The claim of a loss of income from capital assets due to the default of a non-recoverable loan claim presupposes that it has been established with certainty that no more loan repayments will be made. The actual moment in time and circumstances under which the shareholder provided the loan will not be decisive in the future.

In principle, the loss may not be offset against income from other types of income, nor deducted under Section 10d EStG. It only reduces the income that the shareholder generates from capital assets in subsequent assessment periods. Shareholders who hold more than ten percent of the corporation are excluded from the restrictions on deduction of losses and the prohibition on offsetting the losses. In this case, the loss from the receivables default can be fully offset without limits.

For reasons of protection of legitimate expectations, the recognized principles for treating the loan loss as subsequent acquisition costs will continue to be applied, if the shareholder granted the loan before 27/09/2017, or the loan was abandoned before 27/09/2017 when the crises occurred.

LEGISLATIVE CHANGE 2019: APPLICABLE FROM 31/07/2019

Under the Annual Tax Act for 2019, the previous situation prior to the change in the case law was restored. The introduction of a new paragraph 2a in Section 17 EStG provided the legal basis for this. Under this, **loan losses are subsequent acquisition costs, provided** the **grant of the loan or the abandonment of the loan during a company crisis**, was **instigated under company law.** The same applies in the case of defaults of surety recourse claims and comparable claims, provided that the provision or the abandonment of the respective security was initiated under company law. Nowadays, the law also regulates when something has been instigated under company law. This is regularly the case whenever a third party would have demanded repayment or would not have granted the loan or the security under otherwise identical circumstances.

The new wording of Section 17 para. 2a EStG applies for the first time to disposals from

31/07/2019. At the request of the taxpayer, an application of this rule is also possible for disposals before 31/07/2019.

CONCLUSION

The income tax treatment of the loss of receivables from a shareholder's loan to his company can be seen as confusing due to the constant "ping-pong" between case law, the tax authorities and legislative law. In the case of a loss of a shareholder loan, we recommend a critical review of whether there are any actions possible that would guarantee the optimum treatment of the loan loss.

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→ Insolvency risks in company valuations

It is not currently possible to estimate the economic damage caused by the Corona virus. What is clear, however, is that companies in all kinds of sectors have seen a serious collapse in revenues and profits and are therefore faced with existential challenges. For potential buyers and also sellers, it is therefore necessary to adequately consider a potential insolvency risk as part of company valuations. Decisions should not be made on the basis of inflated company values.

SCOPE OF APPLICATION

In principle, it is assumed that the risk of cashflow shortfalls due to defaults will rise along with an increasing level of debt. Studies by various rating agencies show that, as a rule defaults are only likely to occur with "non-investment" grade ratings. Thus, the scope of application can be restricted to the valuation of companies with high levels of debt.

METHODOLOGICAL CONSIDERATION

The company value is calculated technically by capitalisation of the cash flows of the company concerned. The starting point for the consideration of insolvency risks therefore involves both cash flows and the capitalisation factor.

The planned cash flows should regularly have probability rates assigned to them, and be the result of multi-dimensional planning. As a result, as far as possible all realistic future expectations are modelled, and insolvency risks are also included by implication.

In practice, this is not normally the case as planning usually serves strategic management and defines target values. The planning must therefore be adapted to include insolvency risks. The adjustment should take place through the inclusion of accumulated period-specific default probabilities.

In this process, a distinction must be methodically made between an adjustment of the cash flow in the detailed planning phase and that of the terminal value. In the detailed planning period, the period-specific planned cash flow is reduced by the cumulative default probability for the respective period. In the terminal value, the period-specific default probability is considered in the form of a negative growth rate.

It is furthermore necessary to adjust the capitalisation factor, consisting of cost of equity and cost of debt. Cost of equity already reflects entrepreneurial risk through the beta factor. On the other hand, cost of debt still needs to be adjusted. The contractually agreed and/or market listed cost of debt needs to be corrected for the period-specific default probability. This adjustment of the cost of debt also results in a lower expected value of the tax-related relief from debt financing (known as Tax Shield).

QUANTIFYING THE INSOLVENCY RISK

Various options are described in literature for deriving a risk of default (for example, Monte-Carlo simulation or rating-based methods).

Due to their high level of objectivity and standardisation, rating-based methods are given priority in practice. For small and medium-sized companies, it is possible to work with synthetic ratings due to the absence of external ratings in most cases.

Analogous to the derivation of the beta factor for cost of capital analysis, peer companies are also used for synthetic ratings. Criteria for the selection of the peer companies may be financial performance indicators (e.g. equity ratio, total return on capital, interest rate and likelihood of repayment) as well as sector and region. The resulting rating for the benchmark group should be derived for a specific period. It can thus be considered that performance indicators (e.g. equity ratio) change during planning.

Quantifying the risk of default is finally achieved by converting the respective rating into probabilities of default. The rating agencies regularly provide publicly available data records for this purpose. When converting rating classes it should be ensured that the geographical area and sector of the object being valued are taken into account. Otherwise, it can lead to a distortion of the default risk e.g. due to different insolvency rules per jurisdiction.

CONCLUSION

In view of the increasing level of debt in many companies, and the associated increase in the threat of default, the insolvency risk should be included as part of any company valuation. The level of the insolvency risk is determined by a probability of default specific to the time period and the individual company. Both cash flows and the cost of capital need to be adjusted accordingly.

What effect the inclusion of the insolvency risk may have on the value will vary case by case. We would particularly like to point out that it is firstly necessary to analyse to what extent opportunities and risks have already been adequately included, in a balanced way, in the planning of the entity being valued.

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→ M&A Vocabulary – Explained by the experts

"Quality of Numbers" and "Quality of Earnings"

In this ongoing series, a number of different M&A experts from the global offices of Rödl & Partner each present an important term from the English specialist language of the mergers and acquisitions world, combined with some comments on how it is used. We are not attempting to provide expert legal precision, review linguistic nuances or present an exhaustive definition, but rather to give a basic understanding or refresher of a term and some useful tips from our consultancy practice.

The Quality of Numbers and the Quality of Earnings are two fields of analysis during financial due diligence.

As a first step, the *Due diligence* consultant evaluates the reliability of the available numbers (*Quality of numbers*) from the *target* company, by examining:

- whether time-based accruals have been booked correctly (including during the year)
- whether numbers from different sources match (e.g. monthly sales figures vs. annual financial statements)
- which variances exist between the external financial statements and the management accounts and how these are justified.

This analysis is of particular relevance when the planned transaction is a *carve-out*, involving splitting off a specific business activity and its associated assets or companies from a company. In such a case, it must be checked whether the perimeter of the *target* was defined clearly and logically (e.g. allocation of costs for required central services such as accounting and personnel management) and to what extent, if relevant, intercompany charges may affect the figures for the *carve-out*.

If a business plan is part of the scope of the due diligence, it becomes part of the analysis and the due diligence checks its mathematical accuracy as well as its coherence with past figures. Finally, the reader of the due diligence report will gain a clear picture as to with how much "caution" the numbers from the target company must be taken and can already weigh up what measures he or she plans to implement after the transaction to improve the *quality of numbers*.

Based on the findings on the *quality of numbers*, the due diligence can then analyse the *quality of earnings*. In this analysis, which is often at the core of a due diligence, we examine what significance the past numbers for a given earnings figure have as to the underlying profitability of the target company. In practice, the earnings figure most commonly used in this context is *EBITDA*. In order to estimate the underlying profitability of the business model, the chosen earnings figure is adjusted, e.g. by eliminating circumstances which are not inherent to the business model, or which are considered to be non-recurring, such as:

- book gains from the sale of assets
- expenses for unusual legal disputes
- creation and reversal of provisions or specific allowances for bad debts
- income and expenses arising from the effects of changes in methodology
- other operating income and expenses that are attributable to other periods
- unusually high expenses for parties related to the owner

- severance payments and bonus payments to (former) employees that are higher than normal.

If the target company has recently grown through acquisitions non-organically or has been restructured, it may also be necessary to consider *pro forma* adjustments to produce comparable figures for all past periods.

The result of the analysis of the *quality of earnings* is a *normalised earnings* figure, which is often used as the basis for purchase price negotiations.

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Coronavirus: What you need to know

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TOPICS

Effects of the corona crisis on M&A transactions

Even the drafting of share purchase agreements for companies is not exempt from the consequences of the coronavirus. The pandemic has implications for both upcoming and ongoing M&A transactions. Read more »

Corona quick check for decision-makers

Especially in the current times of crisis, the management is thus faced with the question of what issues are included in orderly/conscientious management and what is of particular importance in the current situation. In addition to legal, tax and business management topics, questions from the fields of auditing and IT are essential. Read more »

Set a course: Covid-19 and IT

A key step in overcoming a crisis is for the company to prepare itself for the crisis. The crisis management team has to assess the effects on IT and with it on the company processes by gathering sufficient information about the development of Covid-19. Read more »

COUNTRY TOPICS

Summary of new laws: Germany, France, Italy and Spain
Governments and Parliaments around the world are implementing a wide range of emergency measures to help support businesses in light of the Coronavirus pandemic. In our Guides, organized by topic area and divided by countries, you will find a summary of the main measures adopted in Germany, Spain, Italy and France which are more interesting for business and commercial perspective. Read more »

Covid-19: Kenya's Tax and Economic Measures
The outbreak of the Covid-19 virus around the world in the past two months and the resulting pandemic has significantly disrupted the global economy and Kenya is no exception. Read more »

Labour Law and Covid-19 in Thailand
The Thai government issued further regulations with extensive consequences for employers and employees in Thailand. Read more »

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