Rödl & Partner

M&A DIALOGUE

LEGAL, TAX, FINANCIAL NEWS

Issue: March 2021

In this issue, you can read about

→ German Fund Location Act: Employee Share Ownership Taxation

Owning shares by employees in the company they work for by acquiring them free of charge or at a discounted price is a popular way, especially among start-ups, to create employee loyalty and add value on top of the employees' often low fixed pay.

According to a draft of the German Fund Location Act, an act on strengthening Germany as an investment fund location (German: *Fondsstandortgesetz* or FoG-E), passed by the Federal Cabinet on 20 January 2021, employees of start-up companies should now feel more encouraged to own shares in the companies they work for. The draft law envisages greater tax incentives for this type of employee share ownership.

Taxation according to current legislation

According to current legislation, the granting of company shares to an employee free of charge or at a discounted price constitutes a pecuniary benefit which is normally treated as taxable income. The pecuniary benefit is the difference between the market value of the share and the purchase price paid by the employee. As a rule, the pecuniary benefit accrues to the employee on the date on which he or she acquired the power of disposition over the share in the company. In the case of shares in a limited liability company (German: *GmbH*), this is usually the moment of concluding an effective agreement on the assignment or the takeover of shares (in the case of capital increases).

Even if the employee does not physically receive liquid funds, he or she still earns income in the form of "dry income", which is subject to income tax plus solidarity surcharge and, if applicable, church tax (maximally 47.48 per cent excl. church tax).

If the company share is later sold, any capital gain (gain from the sale > acquisition cost) is taxed as income derived from capital assets subject to final withholding tax (share ownership < 1 percent, effective tax burden of approx. 26.38 per cent incl. solidarity surcharge, excl. church tax) or according to the "partial income method" (German: *Teileinkünfteverfahren*) (share ownership ≥ 1 percent, 40 per cent tax-free, effective tax burden maximally approx. 28.49 per cent excl. church tax).

Taxation according to the draft law

By adding Article 19a to the Personal Income Tax Act (EStG-E), the draft law introduces a taxation deferral model. According to this new rule, if a company share is transferred to the employee free of charge or at a discounted price, taxation may be deferred subject to consent of the employee. This means that the pecuniary benefit is not immediately subject to income tax, and thus "dry income" can be taxed later. Only social security contributions are due.

The tax on the pecuniary benefit only becomes due when

- the company share is sold;
- ten years have passed since the company share was granted; or
- the employment relationship ends.

The subsequent taxation is generally based on the market value of the shareholding at the time of granting. However, if the value of the shareholding decreased after the date of granting, these losses in value are fully taken into account for tax purposes by basing the subsequent taxation on the market value of the shareholding when realised. This means that losses in value are fully taken into account for income tax purposes, whereas increases in value are not. Increases in value are taken into account as income from capital assets when realised in the form of capital gains.

The planned taxation deferral model only applies to companies that meet the EU-defined criteria of a SME (small and medium-sized enterprise) at the time of the granting of shares and have not operated for longer than ten years. Start-up companies normally meet the following thresholds:

- SME: < 250 employees, an annual turnover not exceeding EUR 50 million or an annual balance sheet total not exceeding EUR 43 million.
- Small company: < 50 employees, an annual turnover and an annual balance sheet total not exceeding EUR 10 million.
- Micro company: < 10 employees, an annual turnover and an annual balance sheet total not exceeding EUR 2 million.

The planned taxation deferral model should apply to company shares granted after 30 June 2021.

Conclusion

In contrast to the status quo, the presented draft law along with its tax incentives for employee share ownership is a ray of hope for start-up companies and their employees. It would be an important contribution to strengthening Germany as an innovation hub. We will keep you posted on the legislative process.

For more information please contact:

Dr. Susanne Kölbl
Certified Tax Consultant (Germany)
Partner

Munich (Germany)

T +49 89 9287 80 553
susanne.koelbl@roedl.com

→ Transparency Register: Stricter Reporting Requirements For Companies

With the implementation of the 5th Anti-Money Laundering Directive into German law, a revised version of the Money Laundering Act (MLA) came into force on 1 January 2020. The revised version tightens rules that obligate a large number of companies that had previously not been obliged to report the beneficial owner(s) to the transparency register to make such report. The administrative practices applied by the Federal Office of Administration (being the institution competent for the transparency register) so far regarding the transparency register have been maintained in the Office's FAQs that are available online and kept up-to-date. The Federal Office of Administration last updated these FAQs on 9 February 2020.

Determination of the beneficial owner

In principle, every legal entity organised under private law (in particular limited liability companies (*GmbH*) and public limited companies (*AG*)) and every registered partnership (in particular general partnerships (*oHG*) and limited partnerships (*KG*)), also in multi-level shareholding hierarchies, must report its ultimate beneficial owner to the transparency register.

To that end, it should first be identified what entities act as direct shareholders who hold more than 25 per cent of shares in the company (capital shares or voting rights) or can exercise control in a similar way. If they are natural persons, they must be reported to the transparency register. If they are a company, the shareholding structure of that company should be examined from the aspects of the MLA. The prerequisite for this is that a natural person must be able to exert a dominant influence on the company in accordance with Article 290 (2)-(4) of the German Commercial Code (HGB).

Beneficial owner due to holding veto rights

While beneficial owners were previously identified based on whether they held shares in the company, now, with the changed administrative practice of the Federal Office of Administration, any shareholder who can veto a decision pursued by the general meeting or shareholders' meeting will be considered a beneficial owner. This means that at the level of indirect shareholding, it is no longer assumed that a dominant influence within the meaning of Article 290 (2)-(4) of the German Commercial Code (HGB) is exercised only when the level of shareholding is more than 50 per cent. The Federal Office of Administration now assumes a dominant influence already on the basis of or in the presence of a blocking minority, veto rights and unanimity requirements. If a company's articles of association require a qualified majority for making fundamental economic decisions to be adopted by the general meeting or shareholders' meeting, it is sufficient to have the status of a beneficial owner if the shareholder holds a smaller portion of voting rights. If the articles of association even require unanimity for fundamental decisions to be adopted by the general meeting or shareholders' meeting, each individual shareholder is the beneficial owner, even if the shareholder is a minority shareholder. The same applies if the participation of a shareholder in the decision-making process is required by law or under the articles of association. Control within the meaning of a dominant influence can now also arise from holding a combination of capital shares and voting rights.

Outlook

The legislator is planning to change the law as regards the currently existing legal fictions regarding reporting arising from Articles 20 et seq. MLA. Based on those legal fictions, a large number of companies were previously not required to report beneficial owners, but these fictions are to be completely abolished in the future as the transparency register is being designed as a comprehensive information register.

Conclusion

As a result, especially in the case of multi-level corporate structures, each level of the shareholding structure should be viewed separately. It should be examined separately whether control is or can be exercised through capital shares, voting rights or in any other way. Where control is exercised through capital shares, holding a majority of the capital shares is generally required. Control on the basis of voting rights now no longer requires holding a majority of voting rights, but only the ability of individuals to veto shareholder resolutions on the basis of their voting rights.

Currently, missing or incorrect entries in the transparency register with regard to veto rights such as blocking minorities cannot yet be penalised on the grounds of the principle of legal certainty in administrative offence law – however, the legislator is already planning to change the law in this regard.

For more information please contact

Johannes Gruber
Rechtsanwalt [Attorney at Law/ Germany]
Associate Partner

Nuremberg (Germany)

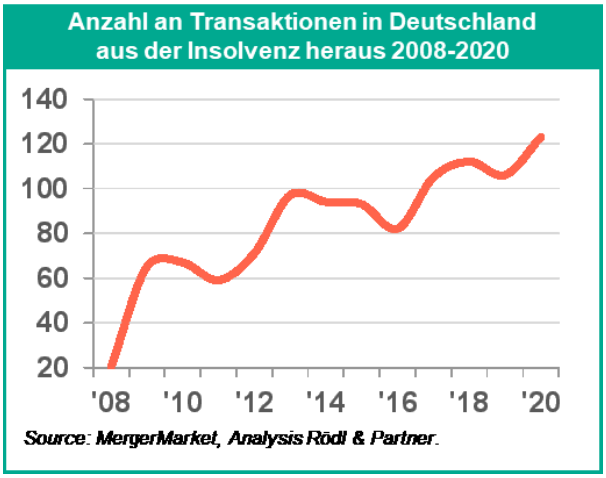
T +49 911 9193 1308
johannes.gruber@roedl.com

Elisabeth Schmidt
Rechtsanwalt [Attorney at Law/ Germany]
Diplom-Betriebswirtin (BA)
Senior Associate

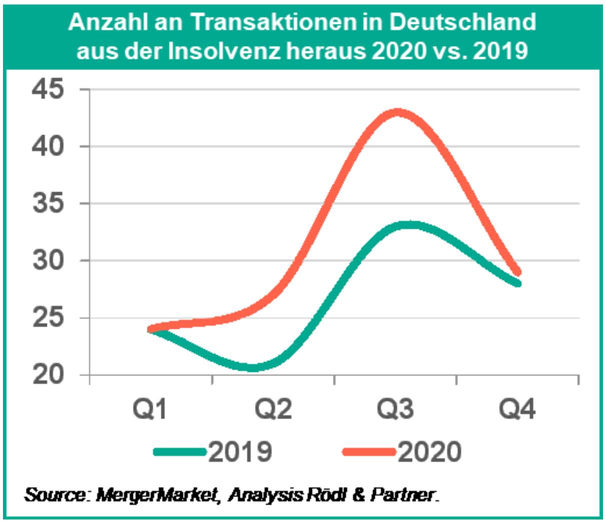
Munich (Germany)
T +49 89 9287 80 322
elisabeth.schmidt@roedl.com

→ Purchase Price Allocations in Restructuring Transactions

As an analysis of the transaction database MergerMarket shows, transactions out of insolvency have steadily increased in Germany in recent years and reached a new record high in 2020.



Due to the global coronavirus pandemic and the associated shocks to the economy, it can be assumed that the number of transactions not only out of insolvency, but generally in the field of restructuring, will also increase significantly in 2021. This can also be inferred from the comparison of the number of transactions out of insolvency in the coronavirus-stricken year 2020 with the year before:



This correlates with an increased number of turnaround investors who have gained extensive expertise in restructuring and mastered the art of turning financially distressed companies or their parts into ample investments.

In these transactions, very low to negative purchase prices can be achieved under certain circumstances as the acquirer assumes liabilities and the upcoming expenses for the restructuring of the target company.

Balance sheet disclosure obligation according to IFRS/HGB

Even with these low or even negative purchase prices, the purchase price allocation must be carried out during the initial consolidation within the course of the consolidated financial statements, both according to German accounting (HGB) and international financial reporting standards (IFRS). In the course of the purchase price allocation, the purchase price is allocated to the acquiree's identifiable assets, liabilities and contingent liabilities that are revalued at fair values. Any remaining difference between the purchase price and the revalued equity constitutes goodwill that must be reported as an intangible assets.

In the case of transactions in the context of restructuring, low purchase prices often lead to a negative consolidation difference, i.e. where the revalued equity (at fair value) exceeds the purchase price paid. In this case, additional regulations on the treatment of such a difference come into play.

German and international accounting principles are consistent with regards to the treatment of negative consolidation differences. Both ultimately require recognising the negative consolidation difference in the profit and loss statement (P&L). However, on a closer look, there are some differences between the approaches which we explain below.

Stronger focus on liabilities

Regarding international reporting standards, purchase price allocations are subject to IFRS 3 'Business Combinations' (*see M&A Vocabulary in M&A Newsletter February 2021*). However, in the case of purchase price allocations performed in the context of restructuring, liabilities should be examined more closely to determine whether contingent liabilities or onerous contracts exist. Here, the regulations of IAS 37 continue to apply, according to which, for example, future operating losses cannot be recognised as liabilities.

The main difference lies in the treatment of contingent liabilities, which, under IAS 37, cannot be recognised and are disclosed in the notes to the financial statements only for information purposes. In the context of acquisitions according to IFRS 3, contingent liabilities (probability of occurrence < 50 per cent) can be recognised and must be carried as liabilities at their settlement amount.

IFRS: Gain from Bargain Purchase

If the revalued net assets exceed the cost, a negative consolidation difference (negative goodwill) arises. If this is due to the acquirer's own bargaining skills and/or bargaining position, the acquirer gets the so-called bargain purchase. This means that the acquirer was able to negotiate a favourable purchase price. According to IFRS 3.36, before recognising a gain on a bargain purchase, the so-called reassessment has to be performed. The acquirer must reassess whether all of the assets acquired and all of the liabilities assumed were correctly identified and measured. Any additional assets or liabilities that are identified in that review must be recognised. This ensures that all information available at the acquisition date has been appropriately considered. If the reassessment confirms that a negative consolidation difference arose, it must be recognised immediately in the P&L (see IFRS 3.34).

HGB: Distinction Between Lucky Buy vs. Gain from Bargain Purchase

According to the regulations of the German Commercial Code (HGB), a negative consolidation difference must first be disclosed on the liabilities side as "goodwill arising from capital consolidation".

According to GAS 23, a distinction should be made between "negative consolidation differences with equity or debt characteristics (the so-called lucky buy) and 'technical' negative consolidation differences".

If the negative consolidation difference arises from a lucky buy transaction, the more specific regulations of the GAS require a scheduled amortization of the difference in profit or loss over the weighted average remaining useful life of the acquired depreciable assets. If the difference is attributable to a non-depreciable asset, the difference is realised upon disposal through unscheduled amortization.

The "negative consolidation difference with debt characteristics" exists if expenses or losses expected at the acquisition date have reduced the purchase price. These can include restructuring expenses, expected losses, but also undervalued provisions. Depending on the circumstances, such a difference must be reversed through the P&L as of the acquisition date or periodically.

A technical difference can result, for example, from a belated initial consolidation of a company acquired some time ago or from the acquisition of an I/C receivable below book value, and should be examined separately on a case-by-case basis.

Conclusion

Generally, the negative consolidation difference, or negative goodwill, is calculated identically under the German and international reporting standards. However, the subsequent accounting can differ significantly and distort balance sheet analyses. Under IFRS, the consolidation differences are recognised immediately in profit or loss, whereas under HGB rules (see GAS 23.144 et seq.) their amortization must be spread over the period in which they arose, or, in some cases, gains from them can even only be realised upon resale of the shareholding.

Purchase price allocations require a detailed analysis of the acquired assets and their proper valuation. In the context of restructuring, low purchase prices involve further requirements to the purchase price allocation.

Professional assistance with the purchase price allocation can help ensure the proper representation of the acquisition and a smooth initial consolidation process, especially in the context of restructuring.

For more information please contact

Andreas van Bebber
CFA
Associate Partner

Stuttgart (Germany)

T +49 711 7819 144 79
andreas.vanbebber@roedl.com

Lukas Schöllhorn
Associate

Stuttgart (Germany)

T +49 711 7819 144 19
lukas.schoellhorn@roedl.com

→ M&A Vocabulary – Understanding Experts

"Letter of Intent (LOI)"

In this ongoing series, a number of different M&A experts from the global offices of Rödl & Partner present an important term from the 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 or refresh a basic understanding of a term and provide some useful tips from our consultancy practice.

Parties to a company acquisition agreement often want to outline their visions about the content and the course of procedure already at an early stage of the planned transaction.

In particular, because of the resources that the seller has to reserve for due diligence and later contractual negotiations, he has a fundamental interest in the potential buyer declaring his basic intention to acquire the seller's company.

Also for the buyer, it may be important to inform the seller in writing of the seriousness of his interest in the contemplated transaction. This is particularly the case if there are a large number of prospective buyers. For this purpose, in practice, the negotiating parties usually sign the so-called Letter of Intent (LOI). The term, which originates from Anglo-American law, should be viewed as a declaration of intent under German law, but it is not defined in greater detail by law. In most cases it is the seller who requests presenting a unilateral letter of intent from the prospective buyer, but in practice an LOI is sometimes also signed by the seller as a bilateral declaration. In this case, the term Memorandum of Understanding (MoU) is often used.

As a mere declaration of intent, the LOI does not constitute an intention to enter into a legally binding relationship. In this respect, the LOI can also be distinguished from *pactum de contrahendo* (a preliminary agreement), which usually establishes a legally enforceable claim for the conclusion of the main agreement.
Although an LOI does not establish an enforceable claim for the conclusion of the respective company acquisition agreement and is

generally non-binding, individual components of the LOI can very well be declared as binding on the negotiating parties. As a result, in the event of a breach of such a binding arrangement, parties may be obligated to pay damages or even contractual penalties. This applies in particular in the case of exclusivity or confidentiality clauses. If, for example, the seller conducts parallel negotiations with other prospective buyers although he has undertaken in the LOI to conduct contractual negotiations exclusively with the specific potential buyer for a certain period of time, he may become liable to pay damages.

An LOI that has content as above is referred to as a "soft" LOI. In practice, so-called "hard" LOIs are also possible, yet they are certainly rare. A hard LOI is signed when the parties not only want to present the mere declaration of intent but to agree in a binding manner on essential elements of the company acquisition agreement, such as the purchase price or the method of its determination. In this case, the arrangements between the parties regarding the later conclusion of the acquisition agreement are already legally binding.

An LOI should essentially be structured in such a way that it first names the parties to the company acquisition agreement and reflects the current status of the negotiations. The description of the transaction itself should be as detailed as possible and the most important deadlines for the planned acquisition process roadmap should be indicated. In addition to exclusivity clauses and duties of confidentiality, an LOI can or should also indicate conditions for the continuation of the contractual negotiations or their termination (depending on the result of the due diligence, if applicable).

Evidently, an LOI should be formulated with great care in order to ensure clarity, especially as regards the binding nature of individual arrangements, and to avoid misunderstandings and ultimately legal disputes from the outset.

For more information please contact:

Stefan Sieferer
Rechtsanwalt [Attorney at Law/ Germany]
Partner

Budapest (Hungary)

T +36 1 8149 880
stefan.sieferer@roedl.com

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Publisher's details

M&A Dialogue |
March 2021 Issue

Publisher
Rödl GmbH Rechtsanwaltsgesellschaft
Steuerberatungsgesellschaft
Wirtschaftsprüfungsgesellschaft
Denninger Straße 84
81925 Munich
Germany
T +49 89 9287 800
www.roedl.de

Responsible for the content
Dr. Susanne Kölbl, Johannes Gruber,
Andreas van Bebber, Stefan Sieferer

susanne.koelbl@roedl.com
johannes.gruber@roedl.com
andreas.vanbebber@roedl.com
stefan.sieferer@roedl.com

Layout/Presentation
Claudia Schmitt