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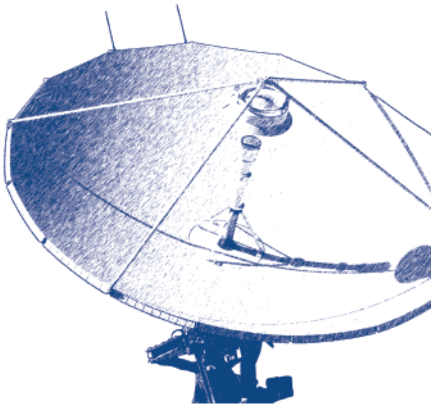
Implications of the Revised Accounting Law for Tax Reporting under German GAAP – What does the new law mean for your German investments?

After the German Parliament adopted the Act on Modernization of Accounting Law (Act), the Act passed the Upper House on 3 April 2009, bringing nearly four years of discussion to an end. In general, the new rules will apply for fiscal years beginning after 31 December 2009; however, earlier application for fiscal years beginning after 31 December 2008 is permitted.

Following the overall objective of the law to modernize German accounting rules, the principles of deferred tax accounting have been fully revised and adapted to the concept of IAS 12. Nevertheless, a number of differences to IAS 12 will remain.

The following provides a brief overview of the revised rules and the consequences for the statutory financial statements of corporations.



1. Tax Reporting for German GAAP Purposes to Date

Deferred taxes currently are determined based on the timing concept, with an option not to recognize deferred tax assets and deferred tax liabilities in the case of a net deferred tax asset. In addition, no deferred taxes are recognized on quasi-permanent differences and on tax loss carryforwards and tax credits. Only few disclosures are required. Since taxable profit usually exceeds accounting profit, deferred taxes are rarely found in statutory financial statements. In practice, no deferred tax reporting is known for German GAAP purposes as is often the case for IFRS or U. S. GAAP accounting.

2. New Tax Reporting Requirements for German GAAP Purposes

Under the new law, the option not to recognize deferred tax assets and deferred tax liabilities in the case of a net deferred tax asset will remain. However, corporations classified as “large” under German Commercial Code (HGB) will have to disclose in their notes from which differences and tax loss carryforwards deferred taxes result and the tax rates that have been used for measurement. The disclosures must be made even if the company does not have a deferred tax asset or deferred tax liability on its balance sheet because it made use of the option.

When calculating deferred taxes, the following new rules need to be observed:

- Following the temporary concept, deferred tax assets and deferred tax liabilities have to be determined for each balance sheet line item irrespective of whether the difference arises from a profit and loss (P&L) effect;
- Temporary differences include quasi-permanent differences, i.e. differences that will not reverse in the foreseeable future in the ordinary course of the business;
- Deferred taxes may arise from tax loss carryforwards and interest carryforwards if there is sufficient evidence that the carryforwards can be utilized within the next five years;
- Deferred tax assets and deferred tax liabilities can be offset; and
- If a net deferred tax asset is recorded, profit distributions may only be made from equity available for distributions that exceed the amount of the net deferred tax asset, and this rule applies accordingly on transfers made under a profit and loss pooling agreement.

Some consequences of the new legislation on deferred tax accounting are still unclear and under discussion, such as the impact on tax consolidated groups.

3. Consequences for Preparation of German Statutory Financial Statements

As a result of the revised rules on deferred taxes and information to be disclosed in the notes, the importance of deferred tax reporting will increase significantly in the future. Although the option not to recognize net deferred tax assets remains, the detailed information to be disclosed in the notes will require each legal entity classified as "large" under the German Commercial Code to perform tax reporting closer to what is currently performed for IFRS or U.S. GAAP purposes. Determining the main sources of deferred tax assets and liabilities might only be prepared by well-trained employees using appropriate tax reporting tools.

However, although tax reporting requirements according to German GAAP will be similar to those under FAS 109 and IAS 12, existing processes and tools might not be adequate to provide all information required to meet the requirements of the new law. Deviations between German GAAP and IFRS/U.S. GAAP rules, as well as practical differences, have the potential to prevent existing systems from being used without substantial modification. In particular, simplifications applied for U.S. GAAP and IFRS purposes resulting from a consolidated, rather than an individual, approach might require adjustments to tools and processes.

Furthermore, it is unclear how deferred taxes in existing tax consolidated groups should be allocated to the legal entities involved. If allocated inappropriately, the acceptance of the tax consolidation by the tax authorities might be at risk since not all of the German GAAP profits may have been transferred under the P&L pooling agreement because of an incorrect recognition of deferred tax assets and liabilities.

Finally, based on the conceptual changes, deferred tax liabilities on past reorganization might have to be recognized upon adoption of the new law. Mainly contributions at carryover basis for tax, but at fair market value, for German GAAP purposes, should not have led to deferred tax liabilities, because the initial P&L difference and the reversal occurred at the level of different legal entities. According to the temporary concept and the balance sheet approach, those reorganizations should retroactively require the recognition of deferred tax liabilities. Based on the new law and the available interpretation, the transition must be shown without P&L effect in the first year of application. Nevertheless, this might lead to a significant decrease of equity under German GAAP and might reduce the possibility of cash repatriation. Therefore, dividend planning in 2009 should also consider the possible effects of application of the Act as from 2010 onwards.

4. Steps to be Performed before Implementation of the New Law

- Review what adjustments are necessary to existing tax reporting processes and tools according to IFRS or U. S. GAAP to meet all requirements under the new German rules.
- If necessary, restructure income tax compliance processes to make tax balance sheets available when preparing financial statements according to German GAAP.
- Review in detail the consequences that will arise from application of the law related to the equity of the relevant entity. Therefore, reorganizations at deviating transfer amounts for local GAAP and tax purposes should be reviewed carefully to estimate possible consequences on future distributions and/or effects on equity according to German GAAP.
- If dividends are to be distributed in 2009, conduct careful equity planning, including transition effects.

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