Rödl & Partner

M&A DIALOGUE

LEGAL, TAX, FINANCIAL NEWS

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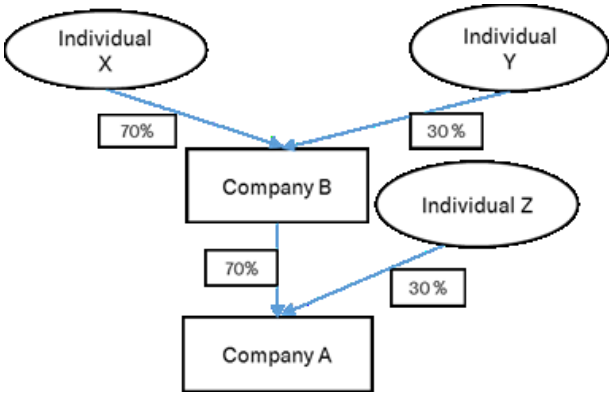
→ Watch your step! Transparency register

The transparency register was created in Germany in 2017, when the law on identifying the profits of criminal activities came into force (Money Laundering Act – GWG) in Germany. Since then, companies, partnerships and foundations have been required to identify their "beneficial owners" to the transparency register.

BENEFICIAL OWNERS

A beneficial owner is a natural person who directly or indirectly holds more than 25 percent by value of the shares in a company, or who controls more than 25 percent of the voting rights. This can also apply to trustors or silent partners. There is no requirement to notify the register if this information is already available in public records, such as a trade register. In the case of companies where no natural person exceeds this 25 percent threshold, the legal representative, such as the Managing Director or the chairman of the board are regarded as the "fictitious beneficial owner". There is no simple answer to the question of whether there is a duty of notification and exactly what information needs to be communicated to the transparency register. However, the following example should serve to clarify the reporting obligations:



X is a beneficial owner of B and A. Due to its 70% stake in B, and consequently its possibility to exercise control over B, B's holding in A is also attributed to X. Any holding above 50 percent implies the possibility to exercise control. Both A and B therefore need to provide information about beneficial owner X to the transparency register, if this is not already available from public records. Whether or not X is resident abroad is irrelevant to the duty of notification.

Y is also a beneficial owner of B, but not of A. The direct 70-percent holding of B in A exceeds the threshold of more than 25 percent, but because its stake in B is only 30%, Y has no possibility to exercise control over A and so no trigger to add in the indirect holding.

Z is a beneficial owner of A and needs to be notified to the transparency register because of his 30% stake. This notification requirement would disappear if, for example, A were a private limited company (GmbH), and Z were registered in the list of shareholders held on the public trade register. If, on the other hand, A were a Gmbh & Co. KG (company controlled by a registered partnership) and if Z were registered as the limited partner with 30 percent of the liability in the trade register, then the requirement to notify the transparency register would still apply. It should be noted, that in the case of limited partnerships, the beneficial owner is visible from the trade register only in exceptional cases. The declaration of liability through the capital structure is not sufficient for this on its own.

NEW TIGHTER RULES AT THE BEGINNING OF 2020

At the beginning of 2020, the transparency rules were redrafted and tightened up even more. Important innovations include:

- The transparency register is now entitled to review the information provided and to request, for example, copies of shareholder agreements and trust agreements.
- "All members of the public" have access to the information in the transparency register - worldwide and without having to prove an interest.
- The "reporting parties" under GWG law, which include notaries and lawyers, are required in every case to compare the information they have about their clients with that held on the

transparency register and report any discrepancies to the transparency register.

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STRICTER REGULATIONS IN THE REAL ESTATE SECTOR

Another more stringent requirement since the start of 2020 lies in the fact that notaries must, before recording the purchase of a property, verify the identity of the beneficial owners, if necessary for both parties, using written documentation to confirm the correctness of the ownership and control structure, and must refuse to notarise the transaction if they are unable to successfully validate them.

In addition, companies whose headquarters are abroad must also notify the identity of the beneficial owner, "if they commit to acquiring a property in Germany". Furthermore, under a newly introduced notarisation ban a German notary may not complete a real estate transaction unless the foreign company can provide proof of an entry in a transparency register. This further ban on notarisation only covers asset deals concluded after 1 January 2020 involving the purchase of real estate by a foreign company. The sale of real estate by a foreign company, for example, or the acquisition of shares in a company whose assets include land, are not covered.

CONCLUSION

Companies should immediately check whether they are compliant with all their duties of notification relating to the transparency register.

In the event of violations of their legal duty of notification, they risk high fines of up to 1 million Euro, and reputational damage, as the decision on fines will be published on the Internet. In addition, the notarisation of a planned real estate transaction may fail or be delayed because the notary involved refuses to authenticate the documentation due to a notarisation ban under the GWG.

FOR FURTHER INFORMATION, PLEASE CONTACT

Dr Alexandra Giering
Rechtsanwalt (German Lawyer)
Associate Partner

T +49 911 9193 3008
alexandra.giering@roedl.com

Sebastian Dittrich
Rechtsanwalt (German Lawyer)
Senior Associate

T +49 911 9193 1309
sebastian.dittrich@roedl.com

→ Establishing the purchase price for a company transaction

Ahead of a company takeover, regardless whether you are buying or selling, one of the core questions is, what is a suitable purchase price, and how you can derive this from the figures of the entity being sold. The variety of approaches to finding a reasonable purchase price often range from the value of the equity, value of the material assets (net asset value), application of the future income stream method or a discounted cash flow method, to a market-oriented purchase price estimate using multipliers (or "multiples"). Especially these last two methods (discounted cash flow method and application of multiples) have become common in the mergers and acquisition market, and are now the most commonly used in Germany. Both methods initially involve the calculation of a company value, although this very rarely corresponds to the final cash purchase price.

In this article, we take a brief look at the theoretical approaches of these two valuation methods, before briefly explaining what adjustments are usually made to the company value in order to reach the final purchase price.

DISCOUNTED CASH FLOW

The discounted cash flow (DCF) method calculates the company value by discounting the free cash flows. When applying the DCF method, a fundamental distinction is made between two calculation approaches: the gross method and the net method.

In the gross method, the company value is calculated in two steps. In the first step, the entire company value is determined by discounting the free cash flows arising in each of the individual planning years. As a second step, the value of equity is then calculated. In practice, the distinction between enterprise and equity value is elementary, and often leads to misunderstandings.

Unlike the gross procedure, when using the net method, the company value is calculated in a single step. For this calculation, the cash flows, which are received by the owners of the equity, are discounted to a present reference date. The discount rate used is the interest rate which the equity holders use to compare returns on equity for investment alternatives.

MULTIPLE VALUATION

In the case of a **multiple valuation,** typical KPIs from the company's figures are collected and compared with those from a peer group. Valuation multiples can, for example, refer to the ratio of company value to turnover, or the ratio of the company value to the EBITDA or EBIT. Sales volumes are often used in situations in which companies are not yet profitable. The approach used most frequently in the market is the EBITDA multiple valuation, since EBITDA represents the closest value to cash from the profit and loss account, and is independent of the financing and tax structure. The multiples used are either derived from listed companies or by looking at comparable transactions.

As already indicated, the company value calculated by means of the procedures described above will only, in the rarest cases, turn out to be the final purchase price. This poor match results especially from two mechanisms that are also taken into account when determining a purchase price: the cash free debt free basis, and the working capital basis.

CASH FREE DEBT FREE BASIS

For the **cash free debt free basis** the liquid items (cash) of the entity being sold are netted off against its (interest-bearing) liabilities (debt). The sum of both items ("Net Debt" or "Net Cash" depending on the net balance) is deducted from or added to the company value. The definition of Net Debt and Net Cash often leads to heated discussions between sellers and buyers (see also the September 2019 issue of the M&A Dialogue newsletter).

WORKING CAPITAL BASIS

The working capital basis ensures that the timing of the sale/purchase does not play a role. It is agreed that the entity being sold should be transferred with the average working capital (current assets) required for operations.

If the working capital is lower than the average required on the transaction date, the purchase price is reduced by the difference between the reference date and the average, or is otherwise increased.

CONCLUSION

There are various valuation methods that can be used in establishing a purchase price. Irrespective of the method selected, it is important to understand that adjustments are frequently applied to the calculated company value, and buyers/sellers should come to an agreement about these at an early stage.

FOR FURTHER INFORMATION, PLEASE CONTACT

Jochen Reis

Partner

T +49 6196 7611 4775
jochen.reis@roedl.com

Tobias Beine
Auditor
Associate Partner

T +49 2 6196 7611 4770
tobias.beine@roedl.com

→ Tax Due Diligence – typical cross-border tax risks

In essence, a tax due diligence serves two purposes: Risk reduction for the potential buyer with regard to the target, and tax optimisation of the transaction process. Insofar as significant tax risks are identified, this can lead to concrete purchase price adjustments or even the termination of the transaction (red flags) in addition to the contractual safeguards in the purchase agreement via tax guarantees and tax waivers.

Special attention is paid here to tax risks in the area of cross-border transactions, as these can lead to genuine cases of double taxation, and also to considerable additional administrative costs. In this article, we would like to offer an overview of typical problem areas, but this cannot be exhaustive given the complexity of the taxes involved.

TRANSFER PRICING

International groups of companies must structure their transfer prices in accordance with arm's length principles, otherwise there is a risk of transfer price adjustments and thus additional tax payments. There is also a risk of double taxation, which must be eliminated through a lengthy mutual agreement procedure, typically involving the use of advisers. In addition, internationally active companies are required to document their transfer prices using formal criteria (3-tiered approach). If no such documentation was prepared, there is a risk of penalties and a considerable administrative effort involving external consultants, which also eats up internal resources.

As part of a tax due diligence, special attention is therefore paid to transfer price risks. Lack of due care in structuring transfer prices is normally covered by a tax waiver. In addition, the buyer will try to shift the indirect administrative costs back to the seller, e.g. via a purchase price adjustment.

RISKS RELATING TO PERMANENT ESTABLISHMENTS

A very typical problem found during tax due diligence is that of unregistered permanent establishments abroad. If a company operates in another country, e.g. through a fixed place of business, or if a local sales representative has (de facto) power of attorney to conclude contracts, a permanent establishment must be registered. Even if there is no formal permanent establishment as such, there may be local registration obligations abroad, where non-compliance can lead to penalties. You must also not forget service permanent establishments, which are included under some double tax agreements (DBAs).

In addition to the not insignificant additional costs created by retrospective registration of a permanent establishment abroad, tax arrears may need to be paid and, as a rule, also punitive interest and penalties. In some countries there is also the threat of criminal tax proceedings, which should be avoided if possible.

Establishing a permanent establishment means that, in addition to the corporation taxes, payroll taxes for local employees also have to be deducted in the respective country, unless this is already being done for other reasons. In such cases, the employer often assumes liability for payment of taxes on behalf of the employee. In these cases, the back taxes paid by a company can multiply by considerable amounts.

The goal of performing tax due diligence, as well as identifying the risks in advance, is to ensure that potential tax arrears and in some cases sizeable penalty payments, can be avoided by negotiating a tax waiver. This also needs to include the administrative costs. Care needs to be taken that negotiations include payroll taxes, VAT and other sales taxes and - depending on the selected purchase price payment arrangements in the purchase contract - the period up to the actual transfer of ownership under civil law.

Through a tax waiver, you can also contractually ensure that no foreign permanent establishments exist.

PAYROLL TAX RISKS

In addition to the payroll tax risks arising from permanent establishments abroad, there are also domestic income tax risks in the cross-border context. It is frequently overlooked that foreign employees who have an employment contract with

a German company, are subject to German income tax for every day that the employee spends in Germany. These include, for example, sales representatives who regularly spend time at the parent company.

In addition, it should be pointed out that many countries have similar regulations to prevent bogus self-employment to those under German law. Bogus self-employment means people who claim to be self-employed, but are actually dependent on employers. From a German perspective, a bogus self-employed person will be classified as an employee. Employment law (e.g. protection against dismissal, paid leave), tax law (income from non-self-employed work) and social security law (contributions to social security) all apply to them. Special attention must therefore be paid during tax due diligence to regularly recurring consultancy invoices from natural persons, both domestically and overseas.

In addition to the numerous legal risks that bogus self-employed status may entail, the income tax risk and the social security risk should be pointed out and must absolutely be covered by a tax waiver. The tax waiver should also cover the period up to the statutory transfer of ownership.

VAT risks

A potential area of risk for internationally active companies is also failure to register for VAT and other sales taxes abroad. Registration may be necessary if, as a result of a work supply, e.g. the assembly of a plant at a foreign customer's premises, the place of supply is relocated abroad and the foreign jurisdiction does not provide for a reverse charge procedure, i.e. no shift of the tax liability to the customer.

Services in connection with real estate are also typical use cases. In online trading, reference should be made to the mail order regulation, which leads to registration obligations abroad if delivery thresholds are exceeded.

As the turnover tax is linked to ongoing business activities, errors very quickly lead to significant tax arrears. Late registrations, notifications and tax payments attract penalties in almost all countries and may incur significant penalties or other fines. Here, security should be achieved through the purchase contract, using a combination of tax waivers and tax guarantees, and should cover the period up to the transfer of statutory ownership.

CUSTOMS RISKS

Finally, we would like to draw your attention to potential customs risks in relation to third countries, meaning all countries outside of the European Union (EU) or the European Economic Area (EEA).

In practice, this often affects online traders who exceed exemption limits and therefore should be liable for customs duty.

Furthermore, there are global problems with determining the customs value of items, including: transfer pricing, licence fees, bonus free-of-charge items or packaging costs.

AND FURTHER TAXES

Last but not least, do not forget excise duties (e.g. energy, alcohol, tobacco or coffee tax) which we will not address in more detail here. We would also like to just note the existence of real estate transfer tax (stamp duty) and other transaction taxes.

FOR FURTHER INFORMATION, PLEASE CONTACT

Diana Fischer
Tax advisor
Partner

T +49 711 7819 144 93
d.fischer@roedl.com

→ M&A Vocabulary – Explained by the experts

Conditions Precedent

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 a basic understanding or refresher of a term and some useful tips from our consultancy practice.

In the case of company acquisitions, the agreement (signing) and execution (closing) of a contract typically occur at separate times. The execution of the contract is subject to preconditions, i.e. it is only when these are met that the contract can be executed. Any preconditions that may delay completion are referred to as "Conditions Precedent". They delay the desired legal impact from taking effect until one or more future events have occurred. These future events are specified in detail by the contracting parties and included in the contract. Conditions Precedent are significant in the transactional practice.

On the closing date, the parties will check and confirm that all conditions precedent have been met in full. Usually, this is recorded in a closing memorandum. In practice, the following conditions are common:

- Submission of proof of all the required internal decisions (such as a shareholders' resolution)
- Submission of all the necessary approvals (such as official permits, like antitrust approval or private acceptances by e.g. lessors, customers)
- Submission of all the necessary approvals from banks
- Proof of the fulfilment of the purchase conditions, e.g., agreeing and executing a settlement with a departing manager.

The buyer should make sure that no relevant assets are removed from the target between signing and closing. If the operations of the company are to be continued, it must be ensured that all required permits and approvals are present. In foreign countries, special attention must be paid to investment law requirements.

The seller should also ensure that the required purchase price can be paid on time and in full. For example, this may entail the buyer providing a bank guarantee for the transaction.

A distinction needs to be made between this and other closing actions or closing deliveries, where the parties agree to carry out further actions or provide other documents. These are not preconditions for the performance of the contract, but rather are further obligations on the parties, which may require expansion.

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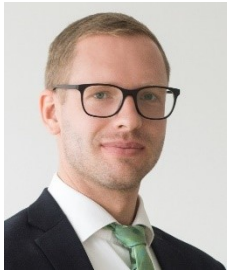

Philip Ende
MSc Finance
Associate Partner

Bangkok, Thailand

T +66 2 0263 258
philip.ende@roedl.com

Martin Chrometzka
Rechtsanwalt (German Lawyer)
Senior Associate

Bangkok, Thailand

T +66 2 0263 258
martin.chrometzka@roedl.com

Publisher's details

M&A dialog |
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Publisher
Rödl GmbH Law Firm
Accountancy Firm
Auditing Company
Denninger Strasse 84
81925 Munich
Germany
T +49 89 9287 800
www.roedl.de

People responsible for content
Dr Alexandra Giering, Diana Fischer,
Jochen Reis, Philip Ende

alexandra.giering@roedl.com
d.fischer@roedl.com
jochen.rice@roedl.com
philip.ende@roedl.com

Layout/Presentation
Franziska Stahl
franziska.stahl@roedl.com