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FEATURED PERSPECTIVES

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''*Eventually, all things merge into one; and a river runs through it.*''

If German tax law was a river flowing over all business transactions and commercial accounting, the last words of Norman Maclean in *A River Runs Through It* best suit the traditional relationship between commercial and tax accounting. For more than 100 years the principle of strict book-tax conformity (or the authoritative principle, or *Maβgeblichkeitsprinzip*) was the most striking feature of German tax accounting. In fact, since the enactment of the German Commercial Code (Handelsgesetzbuch, or HGB) on January 1, 1900, this principle was a pillar that survived all storms of reforms until the last reform, the Accounting Modernization Act (Bilanzmodernisierungsgesetz) went into force on May 29, 2009.

Historically, all transactions and events were first merged into one commercial balance, which was eventually used by tax accounting as a starting point. Of course, there were exceptions that breached the book-tax conformity, but in the end, a German taxpayer that applies German generally accepted accounting principles has to set up only about one and a half balances (in contrast, two separate balances must be set up in the United States).

However, the regime of the hour is the international financial reporting standards. IFRS is an exhaustless source of debates throughout Europe and many other parts of the world — at least for big companies that are in touch with the capital market. For obvious reasons, German lawmakers have refrained from basing tax accounting on these standards, leaving the computation and value of the tax base in the hands of a London-based ''old boys club'' — the International Accounting Standards Board. Yet what suits commercial accounting might not necessarily be good for tax accounting regarding the generation of revenue.

National GAAP have been facing a lot of competition, even though both regimes could not be more different. Whereas IFRS is only relevant for big capital-market-focused group consolidated companies, the German GAAP is applicable to both single and group consolidated accounting. The most significant difference is the perspective. IFRS focuses on investors and seeks a ''fair-and-true view.'' On the contrary, the German GAAP has for more than 100 years taken the view that each position should follow the principle of prudence and that if in doubt, the company will be ''rather poor than rich,'' at least for accounting purposes. The German GAAP focuses on the creditor, not the investor. In essence, there is a clash of the two systems that served as starting point for German GAAP reform.

The shifting to a more fair-and-true view was not taken without controversy. Those advocating this international and modern valuation approach were criticized by those who blame this approach as being one of the catalysts of the global financial crisis.

With the reform Germany partially uncoupled commercial accounting from tax accounting, giving up the authoritative principle to some extent. In a nutshell, commercial accounting strives to match IFRS, whereas tax accounting extends those rules that diverge from commercial accounting and separates elections for tax accounting purposes from those for commercial accounting purposes. However, the era of the authoritative principle is anything but over. It was the aim of German lawmakers to give small and midsize companies the opportunity to stick with this principle for the sake of facilitation and lower transaction costs.

Bookkeeping Exemptions

Sole proprietors are now exempt from having to keep accounts and prepare inventory records if they do not record sales of more than €500,000 or net income of more than €50,000 on the reporting dates of two consecutive fiscal years.

For tax purposes, the ruling of section 141 AO (General Tax Code, or Abgabenordnung) remains relevant and is a guideline for the planned thresholds in commercial law for the keeping of accounts. Sole proprietors who do not exceed the sales and profit thresholds stipulated in section 141 AO could thus restrict their accounting to cash-based accounting section 4(3) EStG (German Income Tax Act, or Einkommensteuergesetz). Cash-based accounting therefore may gain importance in the future.

Goodwill

According to section 246(1) sentence 4 HGB, goodwill acquired for a consideration in the course of a business combination in the form of an asset deal will in the future qualify as an asset with a limited useful life (fiction). It is then amortized systematically over the useful life. Corporations are required to state the reasons justifying the assumption of a useful life of more than five years in the notes to the financial statements.

Before the reform, goodwill acquired for a consideration had to be capitalized as an asset for tax purposes. Variances between the commercial and tax balance sheet may result after the reform from the different depreciation rulings planned. For tax purposes, goodwill acquired for a consideration is not amortized over its customary useful life — as is planned for commercial law purposes — but over a useful life of 15 years. If under commercial law goodwill is amortized over a shorter useful life than in the tax accounts, deferred tax assets will have to be taken into account.

Special Tax-Allowed Reserves

Options allowed under tax law have to be exercised in line with the commercial balance sheet. Under the old rule, tax options were only exercised as long as the carrying amounts in the tax accounts were recognized in the commercial balance sheet. Because of the reform, tax options that diverge from the commercial accounting provisions may be exercised even if they are not disclosed in the commercial balance sheet.

Internally Generated Intangible Assets

One major change involves the internally generated intangible assets. Because of the new ruling in section 248(2) HGB, internally generated intangible assets can be recognized. The former ban on capitalization was partially retained because it is not possible to clearly demarcate the production cost for the internally generated intangible assets from the expenses that pertain to the development of an entity as a whole (that is, internally generated goodwill). In accordance with the principle of prudence, expenses that cannot be clearly allocated are expensed immediately.

The table intends to give some insight on the most important modifications due to the reform.

Conclusion

The partial uncoupling of the commercial from the tax balance is the price for enhancing the international competitiveness of the German GAAP. Eventually, the new German GAAP reduced the gap with IFRS, and created a gap regarding tax accounting. ◆

German Tax Accounting Rules

	Old Rule	New Rule
Bookkeeping Requirement	No exemption.	**Exemption** of some **sole proprietors** from the obligation to keep books and prepare inventory records and annual financial statements.
Goodwill	**Option** to capitalize goodwill acquired for a consideration.	**Duty** to capitalize goodwill acquired for a consideration.
Recognition of Special Tax-Allowed Reserves	**Optional** recognition of special tax-allowed reserves.	**Prohibits** recognition of special tax-allowed reserves (**with** transitional ruling).
Internally Generated Intangible Assets	**Ban** on recognizing internally generated intangible assets.	**Limited duty** to recognize internally generated intangible assets with a restriction on distribution (**with** transitional ruling).
Expense Provisions	**Option** to accrue some expense provisions.	**Ban** on accruing expense provisions that are not recognized for tax purposes (**with** transitional ruling).
Indirect Pension Obligations	**Option** to recognize a provision for indirect obligations.	**Option** to recognize a provision for indirect pension obligations.
Generally Applicable Valuation Principles	Principle of consistency of valuation.	Principle of consistency of **recognition** and valuation.
Provisions	Valuation of provisions at the repayment amount (**cut-off date principle**). Discounting requirement for **cash payment obligations** for hidden interest portions. Valuation method and interest rate for pension provisions **not** regulated in the law.	Valuation of provisions at settlement amount (including future **costs and price increases**). General discounting requirement for **cash and noncash** obligations (average interest rate of the past **seven** fiscal years). Valuation method for pension provisions not regulated in the law, but interest rate to be fixed with **binding effect** (**with** simplification ruling).
Financial Instruments Acquired for Trading	Valuation of financial instruments held for trading at no more than **cost**.	Valuation of financial instruments acquired for trading **at fair value** (**with** restriction on distribution).
Depreciation	**Option** for extraordinary write-down on fixed assets in the case of temporary impairment. **Principle of item-by-item valuation** for fixed assets (for example, developed land). Write-downs for fluctuations in value of current assets are **permitted**. Depreciation based on prudent business judgment is **permitted.** Depreciation that is only permitted for tax law purposes is **allowed**.	**Ban** on extraordinary write-downs of fixed assets in the case of temporary impairment (apart from financial assets). **Principle of item-by-item valuation** for fixed assets (for example, developed land). Write-downs for fluctuations in value of current assets are **not permitted** (**with** transitional ruling). Depreciation based on prudent business judgment is **not permitted** (**with** transitional ruling). **Ban** on charging depreciation that is only permitted for tax purposes (**with** transitional ruling).
Write-Up	Write-up **option**.	Write-up **requirement** other than for goodwill.
Valuation Units	Principle of **item-by-item valuation**.	Permission to create **valuation units** is embodied in the law.
Cost	Lower limit: direct costs.	Lower limit: direct costs, **materials, and production overheads as well as the depletion of fixed assets** (when production related).
Simplified Valuation Methods	The simplified valuation methods permitted besides the weighted average method are the LIFO, FIFO, HIFO, or LOIFO methods.	The **only** simplified valuation methods permitted are the weighted average, LIFO, and FIFO methods.
Currency Translation	Currency translation is not regulated in the law.	Translation at closing **spot exchange rate** (**subsequent valuation**).

German Tax Accounting Rules *(continued)*

	Old Rule	New Rule
Application of IFRS	Application of IFRS to the individual financial statements for **publication** purposes only.	Application of IFRS to the individual financial statements for **publication** purposes only.
Restriction on Distribution	Restriction on distribution for capitalized start-up and business expansion expenses and for capitalized deferred tax assets.	Restriction on distribution for capitalized **internally generated intangible assets,** capitalized deferred tax assets, **financial instruments acquired for trading**, and **assets valued at fair value**.
Deferred Taxes	Capitalization **option** for deferred tax assets. Calculation: profit and loss oriented ''**timing-concept**''; offsetting **required**.	Deferred tax assets **must be capitalized.** Calculation: balance-sheet oriented ''**temporary concept**,'' tax loss carryforwards must also be taken into account (for a limited period of **five years**); offsetting **prohibited**.