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Client Information:

Value added tax 2021 - How to properly prepare for the tax rate increase

Dear Clients,

After a temporary reduction of the value added tax for the second half of 2020 as part of the Second Corona Tax Assistance Act was passed in order to relieve the burden on citizens and companies, the tax rates are now due to be raised again. From January 1, 2021, the standard tax rate will rise again from 16 % to 19 %, while the reduced tax rate will rise from 5 % to 7 %. Once the economic crisis has been overcome, the tax authorities will not hesitate to take a closer look at the business transactions during this unusual period. Here it is important to already take the

appropriate precautions. In the following we have summarized how you can use the resulting opportunities for you and your customers and at the same time to avoid common traps.

1 Tax rate change as of January 1, 2021

Legal background

On July 1, 2020, the temporary reduction in value added tax from 19 % to 16 % (standard rate) and from 7 % to 5 % (reduced rate) came into force as part of the Second Corona Tax Assistance Act. However, the reduced tax rates will only be applicable during the second half of 2020. As of January 1, 2021, the tax rates will be raised again to their previous levels of 19 % and 7 % respectively.

Particularly for private consumers and entrepreneurs not entitled to deduct input tax (e.g. landlords not opting for VAT), the exact time of performance has an economic impact, because this raises the question of whether the regular tax rates or the reduced ones are applicable.

The tax rate, which is to be raised to its previous level from January 1, 2021, could also have a positive advance

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effect, as private consumers and entrepreneurs not entitled to deduct input tax would still like to secure the lower tax rates until the end of 2020. Economists therefore expect that consumer goods, such as electrical appliances will continue to be purchased until the end of 2020.

Depending on the price elasticity of demand and contractual framework conditions, you as a company could have either passed the VAT reduction on to your customers or collected it yourself in the form of a higher profit margin.

According to the draft bill of the Federal Ministry of Finance (BMF), the purchasing power of those who were particularly affected by the Corona pandemic and had a particularly high propensity to consume was to be strengthened. For the year 2020 a budget effect of up to 20 billion € was expected. However, due to the second wave of the Corona pandemic that is currently spreading, the actual consumption and investment behavior in the second half of 2020 still remains to be seen.

Exceptional case gastronomy

The gastronomy sector will continue to benefit until June 30, 2021 from an industry-specific further reduction in sales tax on the consumption of food (excluding beverages) on site. From January 1, 2021, a sales tax of only 7% will be levied instead of the regular 19%. Therefore, the following tax rates will apply in the gastronomy sector (only for food) depending on the period:

Tax Rates Gastronomy	
Period	Value Added Tax Food
until 30.06.2020	19 %
01.07.2020 until 31.12.2020	5 %
01.01.2021 until 30.06.2021	7 %
ab 01.07.2021	19 %

2 Defining criteria Time of performance

Even when the tax rates are changed back to their previous level of 19 % (standard rate) and 7 % (reduced rate) respectively, the defining criterion is the **time of performance**. This determines whether services can still be invoiced at the reduced tax rate.

Remark:

In order to allow customers to benefit from the reduced tax rate until December 31, 2020, deliveries and services should be completed prior to year-end if possible.

Therefore, especially for the hectic end of the year, plan enough time for the formal closing of the respective transaction (e.g. dispatch of goods from the warehouse or joint acceptance with the customer).

Conversely, the purchasing department should work towards a timely or even early completion of the order.

In principle, time of conclusion of the contract, time of the invoice and time of payment are not defining criteria.

Remark:

Many IT systems adopt the applicable tax rate based on the time of invoicing. It may thus be advisable to invoice services, that are provided before the turn of year, at the lower tax rate in the same year in order to avoid manual invoice correction.

In the case of **goods delivery**, the time of performance is the beginning of the transportation, i.e. the day on which the goods leave the company. This applies irrespective of the delivery clauses. Other time periods such as the acceptance of the goods or the date of invoicing are hence not decisive, even if these may sometimes coincide with the date of dispatch ("date of performance equals date of invoice").

In the case of **services**, it is often more difficult to define the time of performance: In the case of construction works, the time of performance is usually defined by the acceptance (including acceptance protocol). If for example, in the case of renting or in the construction industry, partial services have been effectively agreed (e.g. multiple acceptance for each stage of construction), several different performance dates would occur resulting in different tax rates (that might be applicable).

3 IT Convesion from January 01, 2021

As part of the IT tax determination, new, time-dependent tax codes had to be created for the temporary reduction in sales tax. The percentage values of the existing tax codes should not have been changed. For the upcoming increase to the previous level of 19 % and 7 % respectively, you should therefore only have to "reactivate" the existing tax codes.

If you have set up separate tax accounts for the second half of 2020 and manually assigned them to the corresponding tax codes as of July 1, 2020, you will have to adjust them again accordingly to the upcoming tax increase on January 1, 2021.

Remark:

In any case, you should already schedule a meeting with your IT administrator or software service provider.

The experience with the reduction of sales tax as of July 01, 2020 has shown that numerous companies rely on simple, purpose-built Excel tools in areas that are not part of their core business - such as the billing of travel expenses or non-cash benefits to personnel (e.g. company car taxation). Especially regarding these, you have to think about a renewed manual adjustment of the formulas to the new VAT rates.

If the monetary benefit from the provision of a company car is determined on a lump-sum basis, the value added tax during the second half of 2020 in the amount of 16 % is deducted instead of the previous rate of 19 %.

Example:

Given a gross list price of 25,000 €, the non-cash benefit from private use is calculated as 250 € per month using the 1 % method. At a VAT rate of 19 %, a VAT contribution of 39.92 € was incurred until July 1, 2020.

During the second half of 2020, the non-cash benefit of 250 € remained unchanged in total, yet the VAT was only 16 %, i.e. 34.48 €, was incurred each month.

Performing a test run or test purchase

To check whether the tax is correctly determined, as well as whether an invoice is correctly generated, you should carry out a test run (e.g. trial order) together with an invoice generation.

Example:

Some billing systems used to create ancillary costs invoices technically allow only a single tax rate.

Since the service charge settlement for the year 2020 for areas rented out subject to VAT is usually based on monthly partial performances and thus on two different tax rates for both half-years, two different ancillary costs invoices must often be prepared for each half-year.

Remark:

Based on the experience with the reduction of sales tax as of July 1, 2020, it is known that some of the companies affected were not able to adapt their IT systems in time. Therefore, it is crucial to have well-trained sales staff who can also make manual corrections to outgoing invoices until the IT systems are converted.

4 Legal and contractual compensation claims

Occasionally the question arises as to which of the contracting parties is entitled to benefit from the unexpected reduction in VAT. In this context, a distinction must be made as to whether a gross or a net price agreement was reached with the customer.

Net price agreement

In the case of net price agreements, it is precisely those customers who are not entitled to deduct input tax (e.g. private customers or landlords of private apartments who cannot opt for VAT and therefore issue rental invoices without VAT) who benefit directly from the reduction in VAT.

Example:

"Price: 1.000 € plus statutory VAT".

Gross price agreement

Since in the case of a gross price agreement only a fixed gross price has been contractually agreed upon, the performing entrepreneur benefits first as a result of the lower sales tax in the form of a higher margin.

Example:

"Price: 1.190 € plus statutory VAT".

However, regarding long-term contracts the possibility of a claim for compensation may occur under civil law for the reduced VAT burden on the entrepreneur making the payment.

5 Design options before turn of year

Conversion of contracts for partial services

Partial services are economically distinct parts of the thorough service for which the remuneration is agreed separately and which are therefore due instead of the overall service.

Example:

Partial services are available, for example, for the monthly rent of business premises, the monthly ongoing consulting with a lawyer or for monthly deliveries according to framework contracts.

Provided a partial performance has not yet been agreed upon, this is still possible after the start of performance - even in the second half of 2020. What is important is that a partial performance has been agreed upon before its completion.

The BMF maintained the view that a contractual agreement before July 1, 2020 is a prerequisite for the recognition of partial services rendered and accepted before July 1, 2020. Thus, tax authorities manifest that partial payments fall within the period before the tax rate reduction. By analogy, the same applies to partial payments that were agreed upon after July 1, 2020.

Remark:

From a civil law point of view, attention should be paid in the case of services divided into several partial services, in order not to compromise a VAT advantage by dropping warranty claims. Under no circumstances should an incomplete service be accepted in order to shift the time of performance into the second half of 2020. Apart from the risk of tax offences, the client could lose their warranty claims.

Issue of vouchers

Depending on the specific circumstances, it may be reasonable to achieve taxation at the reduced tax rates of 16 % or 5 % by issuing single-purpose vouchers in the second half of 2020, even if the services are only provided from January 1, 2021.

According to the legal definition, a voucher is generally an instrument in which:

- the obligation exists to regard it as a complete or partial consideration for a delivery or service, and
- the goods or services supplied or the identity of the supplier is stated either on the voucher itself or in related documents, including the conditions for using the voucher.

Vouchers which only entitle to a price reduction are not vouchers in the sense of sales tax.

Remark:

A voucher is a single-purpose voucher if the place of supply of goods or services and the VAT due on these sales is known at the time the voucher is issued.

In its letter from June 30, 2020, the BMF had also clarified that in the case of single-purpose vouchers, the date of issue of the voucher is the relevant point in time of taxation and thus for determining the applicable VAT rate. Consequently, the circumstances at the time the voucher was issued are decisive.

In its most recent letter from November 04, 2020, however, the BMF opposes the view that the lowered tax rates could still be secured until December 31, 2020 as described below: According to the BMF, the issuance of a document labeled as a voucher for a binding ordered item, which excludes a later exchange, cash payment or

transfer of the voucher to another seller or buyer and the issuance of which is connected to an obligation to accept, is in effect an advance payment, which is taxable at the time of payment. The value added tax is to be calculated at 16 % or 5 % for payments made before January 01, 2021. However, if the item is delivered after December 31, 2020, the tax must then be adjusted to 19 % or 7 % respectively.

The BMF justifies its view with the fact that, unlike the single-purpose voucher, the performance object is not only determinable, but - as in the case of a binding order - is precisely defined in terms of content. The buyer has no possibility to choose or affect the actual point of delivery. When issuing single-purpose vouchers this statement of the Federal Ministry of Finance must be considered accordingly.

Prioritization in order execution

Since the reduced tax rates will only apply to services rendered up December 31, 2020, deliveries and services to private customers or other entrepreneurs exempt from VAT (e.g. landlords without VAT option, small businesses or non-profit organizations and institutions) could be prioritized in the forthcoming weeks and completed by the turn of year.

6 Potential focal audit points of tax authorities

External audit and special VAT audit

The tax authorities usually have several years - until the administrative finality of the sales tax assessment - to check the correct implementation of the temporary sales tax reduction. Possible instruments therefor among others are the external tax audit (company audit), which in addition to income tax, corporate tax and trade tax usually also covers the sales tax.

The tax authorities also remain free to carry out a so-called special VAT audit. Such an audit can take place, for example, by conspicuous changes from one pre-registration period to the next, for example if a regular monthly turnover tax payment suddenly turns into a comparatively high surplus of input tax refunds.

Major distortions could occur here due to the way in which the turnover and tax amounts during the period of the temporary tax reduction are to be recorded in the declarations for the advance tax return and the annual tax return: The assessment basis for the reduced tax rates of 16 % and 5 % as well as the corresponding tax amount are to be recorded together in the preliminary VAT return for the advance return period and in the annual VAT return for 2020 in the key figures for " Turnover at other tax rates" (lines 28 and 35 of the preliminary VAT return and lines 45, 84

and 96 of the annual VAT return). There will therefore be no differentiation between turnover at the general tax rate and turnover at the reduced tax rate.

Risk profile of buyer and seller

An entrepreneur can be confronted with the following risks: On the one hand, there is the risk that the tax rate applied to the **entrepreneurs providing the services** is too low and that too little turnover tax has been paid. Conversely, if too much tax has been paid, it will still be payable until the invoice has been corrected (see point 7 "Requirement of an invoice correction").

For **receivers of services**, on the other hand, there is a risk that an excessive amount of VAT has been paid on an invoice and claimed as input tax, although the right to deduct input tax would only have existed for a lower tax rate. A certain degree of protection against such risks can be provided by careful monitoring of incoming invoices and the appropriate training of the employees entrusted with this task.

Potential focal audit points including defense approaches

The date of performance is decisive for the determination of the applicable tax rate. In the following, we will present practice-relevant doubtful cases and provide you with possible defense arguments.

- **Acceptance as performance date in the construction industry**

Acceptance usually represents the time of performance of the service. If acceptance took place during the second half of 2020, the tax authorities may have an incentive to recognize the effective acceptance either earlier in the first half of 2020 or later in 2021. You should therefore make sure that the acceptance is documented in the form of an acceptance protocol. In addition, even if the acceptance was not documented during the second half of 2020, an implicit acceptance may still have taken place if the client has already moved into the property before completion of the remaining work.

Remark:

However, to protect yourself from possible consequences under tax law regarding fiscal offences, you should never give in to pressure from customers to issue an incorrect invoice or acceptance.

- **Property as partial performance**

If a partial performance is provided, a separate performance date is set, with the resulting differentiation be-

tween the increased and reduced VAT rates. If a partial performance falls within the period of the second half of 2020 or has been agreed upon for this period, the tax authorities might doubt this. In this case, the information sheet published by the Federal Ministry of Finance on turnover tax in the construction industry, which contains a catalog of possible partial services in Chapter II.2, can serve as an assistance in argumentation.

Remark:

Particularly in the case of construction works, however, the requirements for partial performances are often not met in practice, since partial performances have not yet been effectively accepted in advance or as agreed. In addition, partial acceptances within the framework of the German Construction Contract Procedures (VOB) are often explicitly excluded by contract.

- **Referring to the transitional regulation for revenue in July 2020**

In its letter dated June, 30, 2020, the BMF issued a non-objection regulation for the first month after the changeover (July 2020) for the business-to-business (B2B) sector, as previously demanded by the Federal Chamber of Tax Advisors. According to this regulation, no objections may be raised for services rendered to another entrepreneur if the tax rate reported in July 2020 is too high.

- **Documentation in the form of a written corporate policy**

The complexity of VAT law, the high speed of the repeated change of tax rates and the fact that VAT is often linked to mass transactions on both the purchasing and the sales side, inevitably increases the probability of errors. You should therefore document the VAT requirements and establish precise work procedures for processes, such as invoicing and verification of incoming invoices. Such documents then become part of a tax compliance management system (so-called Tax-CMS).

Remark:

When adjusting the VAT rates in IT systems, most programs create a programming protocol that records the changes that have been made.

7 Requirement of an invoice correction

If the receiver of the service is rejected full input tax deduction on the grounds of the turnover tax statement in the incoming invoice for the purchased goods and ser-

vices being overstated, he should demand an invoice correction from his supplier. The receiver is legally entitled to the issue of a formally correct invoice, unless the service is VAT-exempt (e.g. credit transactions or renting). If the entrepreneur refuses to issue a correct invoice, this constitutes an infringement that can be punished with a fine of up to 5,000 €.

The provider can correct the invoice. In its letter of September 18, 2020, the BMF has taken a stand on the conditions and legal consequences of correcting an invoice.

Remarks:

A correction may also result in the cancellation of the original invoice and the issuance of a new one.

According to the BMF, a formally incorrect invoice could only be corrected if it originally contained the following five characteristics:

- Issuer of the invoice
- Beneficiary
- Service description
- Remuneration
- separately stated VAT

Correction of advance payment invoices is not mandatory

In case of invoices for partial payments received before July 1, 2020 for services performed after June 30, 2020, the VAT rates of 19 % and 7 % applicable until June 30, 2020 had to be indicated in these invoices.

An invoice correction for previously issued advance payment invoices is not necessary if a final invoice shows the VAT for the entire service or partial service with the reduced VAT rates applicable from July 1, 2020.

Remark:

It is already becoming clear that especially the regulations on advance payment invoices can often cause confusion and these invoices are often mistakenly believed to be incorrect. For example, advance payment invoices are still to be issued at 16% (at the standard tax rate) by the end of the year, even if 19% VAT is to be shown in the final invoice in 2021.

However, if it is certain that the respective service will only be rendered after December 31, 2020, the BMF does not object if the tax rate of 19 % or 7 % applicable at that time is already applied in the advance payment invoice. The receiver of such an invoice can then also claim the reported tax amount as an input tax. Conversely, the service provider is still liable to pay the incorrectly overstated VAT until the invoice is corrected if the VAT rate of 19 % or 7 % has been charged on an advance payment invoice prior to July 1, 2020, whereas the payment was only received after June 30, 2020.

8 Conclusion

The remaining time until the end of the year should definitely be used in an effort to benefit from the temporary VAT reduction. At the same time, you should already start preparing yourself for possible audits by tax authorities.

Should you have any questions regarding the upcoming VAT increase and related transitional issues, please do not hesitate to contact us.

Kind Regards
Your ATC Team