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Reduction of
the VAT rate

1 July 2020 to
31 December 2020

Dear Sir or Madam,

The corona crisis has presented Germany with unprecedented challenges and consequences for business that nobody could have predicted. The economic consequences include short-time working, loss of workforce and production, loss of customers, shorter opening hours or even company closures. With its decision of 3 June 2020, the governing coalition has decided on various measures to combat the consequences of corona. In the meantime, the federal government has presented a draft law. Readings in the German parliament are scheduled for 17/18/19 June, with the Bundesrat's consent being expected for 26 June. The aim is, first and foremost, to strengthen the economy and economic power in Germany. The central element of these measures is the temporary reduction of the VAT rate from 19% to 16% and from 7% to 5% for the period from 1 July 2020 to 31 December 2020. This short-term reduction in VAT rates leads to a comprehensive short-term need for action for companies: Cash register and merchandise management systems, processes and financial accounting must be adapted, contracts may have to be changed.

The changes in VAT rates apply, in particular, to areas such as partial services, advance payments, vouchers and recurring invoices. At the same time, it should be remembered that the changes must be reversed in six months.

In the following, we would like to show you selected problems and questions associated with the planned reduction of the VAT rate.

On 15 June 2020, the Federal Ministry of Finance (BMF) published a draft implementation letter on the VAT rate change, which we have taken into account in our comments.

Should you have any additional comments or require further explanations, please feel free to contact us at any time.

Yours sincerely

Your PKF Team

REDUCTION OF THE VAT RATE 2020

1. Taxation principle

The reduction in VAT rates applies to supplies of goods, services and intra-Community purchases during the period from 1 July 2020 to 31 December 2020. As regards VAT on importation of goods, the reduction applies to imports made during this period.

Irrespective of the contractual arrangement or accounting, the date of performance is always decisive for resulting VAT amount. This applies regardless of whether the supplier is taxed on its turnover according to remuneration as agreed (so-called taxation on accruals basis) or remuneration as received (so-called deferred taxation).

A supply of goods is generally deemed to have been completed when the purchaser obtains the right of disposal over the deliverable. In contrast, other services, including services based on a contract to produce a work, are deemed to be completed as soon as performance is completed or finished. The determination of the time of

performance can be difficult, especially in the area of contracts to produce a work (*'Werkvertrag'*) since it must first be examined whether a work was delivered or whether a work was performed. If the manufacturer of the work has itself procured at least one main material of the work to be produced, work delivery is deemed to exist, where performance typically requires handover and acceptance in the sense of approval of the proper contractual performance by the customer. If, on the other hand, the supplier does not procure any materials or only minor items, this then constitutes work performance which has already been rendered when the supplier completes the work, i.e. typically upon completion of his work.

Specific reduction of the VAT rate for the catering sector

A particular challenge is the overlap in time between the reduction in general VAT rates and the specific reduction of the VAT rate for the catering sector. Companies pro-



Specific reduction of the VAT rate applies for the catering sector

viding restaurant and catering services (except for beverages) will be subject to

- » a **5% VAT rate** for a period of six months from **1 July 2020**,
- » then to a **7% VAT rate** for a further six months and
- » from **1 July 2021** to the previous standard VAT rate of **19%**.

Vouchers

When issuing vouchers, the distinction provided by law between vouchers whose handing over is equivalent to a supply of goods or a service (single-purpose vouchers) and vouchers for which only the subsequent supply of goods or a service is subject to VAT when the vouchers are redeemed, becomes much more difficult due to the temporary change in VAT rates at least for the period until the end of 2020. Under the current legal situation, a voucher that can be redeemed during, before and after the transitional period cannot be a single-purpose voucher since the applicable VAT rate is not fixed. While newly issued vouchers can be designed with regard to redemption periods in such a way that these requirements are met, the effects of the change in VAT rate on single-purpose vouchers already issued for which the legal requirements are subsequently no longer met are still unclear.

Invoice receipt check

The invoice receipt check is also of greater importance due to the short-term nature of the VAT rate change. The situation is particularly critical if the input VAT shown in incoming invoices is too high, because, for example, a VAT rate of 19% is claimed for a turnover for which only

16% VAT is in fact payable. In this case, part of the VAT charged is too high. On the one hand, the VAT shown on the invoice must be paid in full by the supplier, whilst the customer cannot claim the excess amount of VAT as input VAT.

Recommendation: In order to minimise the VAT burden, customers who are not fully entitled to deduct input VAT should especially consider shifting services to the period in which the reduced VAT rate applies. Room for manoeuvre may also exist within the scope of existing customer/supplier relationships. In the case of work deliveries, for example, one option would be not to accept a work completed before 1 July 2020 until the six-month period after completion. Companies who issue so-called single-purpose vouchers should consider determining the periods in which the voucher can be redeemed in such a way that the vouchers can only be redeemed alternatively either in periods with a standard VAT rate of 19% or 16%.

Please note:

It can be assumed that the tax authorities will closely examine the time of actual performance, especially in the period between 1 July 2020 and 31 December 2020. In order to avoid back taxes or to ensure the deduction of input VAT, greater attention should be paid to the exact determination of the time of performance and its documentation (for instance, in the form of acceptance reports, etc.).

2. Taxation of partial performance

Partial performance refers to economically delimitable parts of an overall performance for which remuneration was agreed separately in each case, so that instead of overall performance, these individual partial performances are owed.

Partial performance is subject to the following conditions:

- » Economic divisibility of performance
- » Separate acceptance in case of a work delivery/completion in case of work performance
- » Separate agreement
- » Separate accounting

Each partial performance is treated separately for VAT purposes. If partial performance hence takes place during the period in which the VAT reduction from 19% to 16% applies, the customer who is not entitled to deduct input VAT will save 3 percentage points (with the corresponding advantage totalling 2 percentage points in the case of a VAT reduction from 7% to 5%). It goes without saying that this will only apply if the supplier passes on the VAT benefit, either voluntarily or due to a legal obligation.

Recommendation: : If performance subject to the regular VAT rate cannot be provided in the second half of

2020, VAT will be charged at a rate of 19%. If, on the other hand, the performance in question is broken down into partial performances in good time, the reduced VAT rate of 16% can be claimed at least to this extent. Against this background, it might be of interest to split up performance into partial performances ending in the favoured period.

Note, however: Performance cannot easily be divided into partial performances.

- (1) **Economic delimitability:** According to the principle of uniformity of performance, it is not permissible to divide a supply of goods or a service into separate elements of supplies and services.
- (2) **Separate agreement:** It must be evident from the contract that separate remuneration was agreed for parts of the total performance in the favoured 2nd half of 2020. In case of continuous obligations partial performances can be agreed by adjusting the contract previously based on a uniform benefit.
- (3) **Separate accounting:** The partial performance must be invoiced separately and in accordance with the contract. Examples: Typical cases of partial performance are continuous obligations (rent, lease, etc.) if the payments for the individual partial periods are agreed separately. Furthermore, partial performance is also possible for construction work, depending on the circumstances of the individual case, in the form of a separation between structural and finishing work, masonry and plastering work, etc.
- (4) **Actual implementation:** Acceptance of partial performance requires actual fulfilment of the contractual agreements, i.e. if the written form was agreed for acceptance, acceptance of partial performance

must also be recorded separately in writing. Acceptance of part of an overall construction work carried out solely for tax reasons will not be recognised as partial performance. This will be assumed if the consequences of acceptance (due date of remuneration, reversal of the burden of proof for defects of the work, transfer of the risk of loss of the partial performance to the customer/client of the work) are actually excluded as a whole or in part. Mere postponement of the commencement of the limitation period for claims for defects to the time of acceptance of the entire work does not in itself prevent partial acceptance.

In the case of the construction industry, for example, partial performance must be accepted in the 2nd half of 2020 or a work must be completed or finished in the 2nd half of 2020. The contract to produce a work must state that separate remuneration has been agreed upon for parts of the overall performance.

The contract to produce a work typically contains a set of service specifications, quantities and prices. Only if the specifications contain such individual items partial performance can be assumed. If only one fixed price for the entire work is agreed upon, partial performance is excluded. Furthermore, partial performance must be invoiced separately in a corresponding invoice. Accounting must comply with the contractual agreements.

When assessing whether partial performance exists, the tax offices examine the following documents:

- » Contract to produce a work and the service specifications
- » Construction file
- » Hourly wage slips of workers
- » Minutes of meetings between client and contractor.



Please note:

In order to check whether partial performance exists, the tax authorities usually request not only the contract documents, but also inspect other documents. In order to facilitate proof, minutes of meetings and notes regarding the agreement and the related partial performance should therefore be recorded, for instance.

3. Taxation of advance payments

Due to the change in VAT rate, advance payments on services already performed that were also made before 1 July 2020 must be charged at the VAT rate of 19% applicable at the time of the advance payment; accordingly, the invoice must show 19% VAT. The customer can deduct input VAT at a rate of 19%. If advance payments on services performed during the period from 1 July 2020 to 31 December 2020, are also made during this period, the reduced VAT rate of 16% will apply.

If, in the case of individual projects, performance and advance payments fall within both the period of the applicable tax rate of 19% and the period of 16%, it must be clarified how VAT is to be handled. Two alternatives must be generally distinguished here:

1. Advance payments at 19%, performance in the period between 1 July 2020 and 31 December 2020 at 16%

If performance takes place between 1 July 2020 and 31 December 2020, the supplier must declare and pay the difference between the original VAT on the advance payment (19%) and the final VAT (16%) and adjust the invoice in such a manner that the customer is entitled to a reduced input VAT refund under the general conditions of deduction.

2. Advance payments at 16% between 1 July 2020 and 31 December 2020, performance after 1 January 2021

The same applies to advance payments made between 1 July and 31 December 2020 if the associated per-

formance only takes place after 31 December 2020. If advance payments are taxed at 16% in this case, the 3 percentage points must be subsequently taxed from 2021 onwards and the invoice must be corrected. Under the general conditions of input tax deduction, the customer is simultaneously entitled to an increased input VAT refund.

Please note: In both cases, however, invoices do not have to be adjusted as a simplification measure if the tax difference for the advance payments already made is shown in the final invoice or a later advance payment invoice.

As an exception to the principles mentioned above, the tax authorities (optionally) allow advance payment invoices to be issued before 1 July 2020 at a rate of 16% on condition that it is already certain that performance will take place during the period between 1 July 2020 and 31 December 2020.

Example: A supplier provides a performance to a customer entitled to deduct input VAT in September 2020. The customer makes an advance payment for this in June 2020.

Variant 1: The supplier settles the advance payment with 19% VAT in June 2020 and receives it in the same month. He reports and pays the VAT for June 2020. The customer can claim input VAT of 19% for June 2020.

If performance takes place in September 2020, the supplier will issue an adjusted advance payment invoice for the June payment showing 16% VAT and will receive the VAT difference to the amount of 3 percentage points



(entering the assessment basis in line 28 and parallel, with a negative sign, in line 26 or 27, respectively, of the VAT return). At the same time, the customer must adjust his input tax by this amount.

Variant 2: The supplier already settles the advance payment with 16% VAT in June 2020. He must then report the VAT in his VAT return and pay the corresponding VAT amount for June 2020. The customer can already deduct input VAT of 16% for June 2020.

Side note: Construction services

In the case of construction services, work which is carried out can often be economically separated, but there is no agreement on partial performance, so that for tax purposes such work is not considered partial performance. As a result, the entire performance is completed

at the VAT rate applicable at the time of performance, i.e. completion of the construction work. Consequently, if construction work is carried out between 1 July and 31 December 2020, the entire performance will be taxed at a rate of 16%. This is independent of the extent to which advance payments have already been made at a VAT rate of 19%. Advance payments with a VAT rate of 19% will then be adjusted according to the above rules. Construction work carried out from 2021 onwards is taxed accordingly in full at a VAT rate of 19%.

In order to be able to tax partial performance of construction services at a lower tax rate, it is necessary to agree on these partial performances. If no agreement was so far made, the tax authorities will recognise it in accordance with the current draft of the BMF letter if this is carried out by the time the tax rate change comes into effect (in this case by 1 July 2020).

4. Price adjustments

The supplier must check whether he has to make a price reduction for contracts already concluded before 1 July 2020, taking into account the old VAT rate, if performance will only take place after 30 June 2020 and will therefore be subject to the lower VAT rate. In this respect, the **contractual agreements** between the parties are relevant. The obligation to make a temporary price reduction due to the lower VAT rate depends on whether gross or net prices were agreed upon.

In the case of supplies of goods and services carried out after 30 June 2020 which are based on a contract concluded before 1 March 2020, one party to the contract may demand compensation from the other for the higher or lower VAT burden, unless otherwise stipulated in the contract. This means that the customer could require that the supplier pass on the lower VAT burden to the customer.

Recommendation: In all cases in which contracts are regarded as invoices (primarily in the case of so-called recurring services), it must be examined whether these have to be adjusted to the respective change in the VAT rate, irrespective of whether a price adjustment has to be made.

In the case of contracts concluded in the period from 1 July 2020 to 31 December 2020, it should be noted that this is only a **temporary reduction in the VAT rate** and that, depending on the price agreement, prices may be adjusted again on 1 January 2021.

When it comes to drafting contracts, the legal regulation must also be taken into account according to which compensation for the higher VAT burden can be claimed for sales after 31 December 2020 if these are agreed upon during the period from 1 July 2020 to 31 August 2020.

5. Changes in remuneration

The VAT effects of reductions in remuneration (bonuses, discounts, rebates, etc.) or increases in remuneration (retroactive charges) are to be determined using the tax rate that also applies to the underlying transaction.

Recommendation: The calculation of the VAT effects of changes in remuneration sometimes involves a consid-

erable amount of work. However, according to the draft letter from the Federal Ministry of Finance (BMF), the tax authorities will grant various **simplifications** for remuneration changes when different VAT rates apply before the cut-off date of the change or for annual bonuses. It should be decided whether these rules can be used to optimise the adjustment effort from a cost-benefit perspective.

6. Further remarks

In addition to the topics covered here, there are numerous other issues and individual questions that arise depending on the specific sector, type of contract, etc., which would go beyond the scope of this communication.

Other specificities may arise, for example, in the case of

telecommunications services, the supply of electricity, gas and heat, the return of empties, passenger transport and in the hotel and restaurant industry.

The VAT experts at PKF will be happy to help you clarify any questions and problems that may arise and to manage the change in VAT rates.

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