The German Law to Modernise the General Conditions for Capital Investments (MoRaKG)

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1. Introduction

The German parliament adopted the MoRaKG (2) with the aim of giving tax incentives for risk capital investments. The law was subject to a standstill clause pending Commission approval. After the law had been notified in summer 2008, the Commission opened a formal investigation procedure in January 2009 (3). Third party comments confirmed the Commission’s doubts, so on 30 September 2009 the Commission took a negative decision (4), under State aid rules, on the business tax break (Gewerbesteuerbefreiung) for Venture Capital Companies (5) (VCC – Wagniskapitalbeteiligungsgesellschaft) and on the right of Target Enterprises (6) (TE) acquired by VCCs to carry forward losses. At the same time, the Commission authorised income tax benefits for private investors subject to certain conditions.

2. State aid measures in the MoRaKG

2.1. Business tax break

In German tax law, profits are in principle subject to business tax (Gewerbesteuer) if the activity qualifies as a business activity. However, if the activity is characterised as asset administration (Vermögenverwaltung) rather than a business activity, the sale of the underlying investment may not be subject to business tax. The German Minister of Finance issued a circular letter (7) to clarify the distinction. This letter gives guidance on whether the activities of venture capital funds and of private equity funds qualify as asset administration. According to Germany, the MoRaKG aimed at statutory clarification of the letter with respect to VCCs, but would not have introduced any novelty or changed current practice.

When it opened the formal investigation procedure, the Commission questioned whether the MoRaKG was a mere clarification of the letter, as it found some substantial differences. Moreover, the Commission could not find a justification for the following:

- only VCCs falling under the MoRaKG definition, but not other companies with similar activities, would benefit from the statutory clarification;
- the German authorities’ estimate that the measure, which allegedly merely clarified the existing situation, would lead to € 90 million loss in State tax revenue.

In the final decision, the Commission concluded that its doubts had not been dispelled and the clarification deviated from the provisions of the circular letter. Consequently, some VCCs could benefit from the tax exemption under the MoRaKG while they would be liable for business tax under the circular letter. This also means that the measure is selective and involves State aid to such VCCs.

2.2. Right to loss carry-forward

The right to carry forward losses allows a company’s losses in a given year to be taken into account in its tax declarations in future years. However, this also permits abuse when so-called shell companies which have ceased their activities but accumulated losses are sold, as their loss carry-forwards still represent a value for tax purposes. A purchaser of such a company will benefit from a reduction of its future taxes by deducting the losses of the shell company.

In 2008, Germany introduced restrictive anti-abuse rules on loss carry-forward in corporate taxation. These rules prohibit the carry-over of losses if the ownership structure of a company changes substantially. The MoRaKG intended to relax the anti-abuse rules for VCCs that buy shares in TEs. In principle, Germany agreed that the measure is selective and favours both TEs and VCCs. Germany, however, claimed that it was justified by the nature and logic of the German tax system, as the right to loss carry-forward already existed. In addition, Germany also

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(5) The MoRaKG definition of a VCC states that it must be recognised by the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht). Furthermore the VCC must have its domicile and its corporate management in Germany.

(6) A TE must be an incorporated enterprise and must, at the time it is acquired by a VCC, have less than € 20 million owner's equity and have been founded less than 10 years ago.

pointed out that the introduction of the restrictive rules in 2008 put the German venture capital market in an underprivileged situation.

The Commission noted that the venture capital market includes other investment companies which may also invest in TE and should, therefore, be able to benefit from the loss carry-forward. The Commission found that the re-establishment of the right solely for a specific group of companies (VCCs and TEs) could not be claimed to stem from the nature and logic of the tax system. In its comments, the German Private Equity and Venture Capital Association (Bundesverband Deutscher Kapitalbeteiligungsgesellschaften e.V.) also advocated uniform legal and fiscal conditions applicable to the whole venture capital market.

Germany also claimed that the measure would not affect trade between the Member States, since its objective was national compliance with the Notice on Business Taxation (8) and it gave no advantage to German companies compared with companies resident in other Member States. However the Commission pointed out that the beneficiaries may be involved in trading with other Member States. The point of reference for assessing whether an undertaking receives an advantage likely to distort competition and affect trade, as defined in the State aid rules, is always the system generally applicable in the Member State concerned. Therefore the Commission concluded in its final decision that the measure was selective and involved State aid to TEs and VCCs.

### 2.3. Income tax benefit for private investors

The income tax benefit would be granted to private investors, such as business angels, if they realise a capital gain on selling their interest in a TE. No tax advantage would be granted if the sale leads to a loss. Germany claimed that the measure benefits individuals; therefore it does not constitute State aid.

The Commission, however, found that TEs would indirectly benefit from State aid.

Germany stressed that the tax benefit per investor is limited to €22,500 and is contingent upon uncertain future profits. Therefore its impact on present investment decisions is rather limited. Consequently, the measure’s indirect advantage to TEs is unquantifiable and negligible.

The Commission, however, found that a single TE may benefit from several, potentially successive, investments by different private investors. Yet, as the aid is unquantifiable and there is no register for successive investments, the aid would be non-transparent. Therefore the Commission found that TE could theoretically benefit from indirect State aid exceeding the de minimis threshold of €200,000. Germany, however, could not align the measure with the De Minimis Regulation (9). Being non-transparent aid, the De Minimis Regulation would require all private investments into TEs to be declared as de minimis aid. This would include investments where no aid is granted to the investor at all. This is because the provision of the aid is contingent upon future capital gains while the de minimis declarations have to be submitted at the time of investment.

### 3. Internal market aspects

The MoRaKG definition states that VCCs should have their domicile and corporate management in Germany, so the Commission also considered that the business tax exemption for VCCs and the right of TEs acquired by VCCs to carry forward losses were incompatible with the principle of freedom of establishment.

Such a requirement infringes the right of companies to establish themselves anywhere they choose within the Internal Market. The Commission therefore concluded that business tax breaks and the right to carry forward losses were incompatible with the Internal Market and could not be implemented.

### 4. Compatibility of the measures with State aid rules

The measures were assessed under the Risk Capital Guidelines. State aid in the form of risk capital cannot be granted to large enterprises, firms in difficulty or firms in the shipbuilding, coal and steel industries. However the business tax break measure and the right to carry forward losses did not exclude such undertakings, meaning that the scope of these measures is not compatible with the Risk Capital Guidelines.

Some other requirements under the Guidelines are also not met, e.g. maximum level of investment tranches, restriction to expansion stage of target enterprises, cumulation and reporting obligations, etc. The Commission did however approve the income tax benefit for private investors measure under the Risk Capital Guidelines, subject to certain conditions. The Commission agreed that the measure has a general positive effect in the sense of stimulating the provision of risk capital and does not infringe the freedom of establishment principle. Consequently, the Commission invited Germany to bring

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this measure into line with the Guidelines(10) and inform the Commission of the amendments within two months.

5. Follow-up

By letter of 2 December 2009, the German authorities informed the Commission that they would not implement the business tax break and the right to carry forward losses contested by the Commission and they would inform the Commission if they aligned the income tax benefit for private investors with the Risk Capital Guidelines.

Germany informed the Commission that it would not implement any of the measures.