COMMISSION DECISION

of 30.09.2009

on the State aid No C2/2009 (ex N 221/2008 and N 413/2008)

which Germany intends to grant

to modernise the general conditions for capital investments

(ONLY THE GERMAN VERSION IS AUTHENTIC)

(Text with EEA relevance)
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THE COMMISSION OF THE EUROPEAN COMMUNITIES,
Having regard to the Treaty establishing the European Community, and in particular the first subparagraph of Article 88(2) thereof,

Having regard to the Agreement of the European Economic Area, and in particular Article 62(1)(a) thereof,

Having called on interested parties to submit their comments pursuant to the provisions cited above\(^1\) and having regard to their comments,

Whereas:

1. **PROCEDURE**

   (1) By letter dated 30 April 2008, registered at the Commission on the same date, the German authorities notified the Commission of two measures related to the liability for trade tax and to the exemption from the restriction on loss carry forward (N 221/2008) for legal certainty. By letters dated 26 June and 23 October 2008 the Commission asked for additional information. Germany responded by letters dated 24 July and 21 November 2008, registered the same date.

   (2) In addition, by letter dated 22 August 2008, registered at the Commission on the same date, the German authorities notified the Commission of a third measure on a tax break for individual investors (N 413/2008) for legal certainty. A meeting between the German authorities and DG COMP took place on 9 October. Thereafter Germany submitted additional information by letter dated 19 November 2008, registered the same date.

   (3) On 28 January 2009 the Commission opened the formal investigation procedure on all 3 measures. The summary of the decision was published in the Official Journal on 14

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\(^1\) OJ C 60, 14.3.2009, p. 9

European Commission, B-1049 Brussel - Belgium. Telephone: (32-2) 2991111.
March 2009.\textsuperscript{2} The German authorities submitted their observations on 3 March 2009, registered the same date. Third parties submitted their comments on 9 and 14 April 2009, registered the same date. The German authorities were informed about those comments on 23 April 2009, and Germany submitted its response to these comments on 22 May 2009, registered the same date.

2. **DESCRIPTION**

2.1. **Objective of the measures and budget**

(4) The notifications include three tax measures and two definitions of beneficiaries. All measures have been incorporated in a law (*Gesetz zur Modernisierung der Rahmenbedingungen für Kapitalbeteiligungen*, hereinafter: MoRaKG). Those measures have the common objective of supporting the provision of private venture capital to a specific group of companies, defined as "target enterprises" (hereinafter: TE).

(5) The first measure (registered under N 221/2008) aims to facilitate the provision of risk capital by applying specific eligibility criteria for "venture capital companies" (hereinafter: VCC) to be exempted from the *liability for trade tax* (*Gewerbesteuerpflicht*). Due to the implementation of this measure Germany estimate the tax revenues to decrease by € 90 million per annum.

(6) The second measure (registered under N 221/2008) mitigates the restrictive anti-abuse rules on loss deduction allowing the TE to *carry forward the losses* if a VCC acquires its shares. Germany estimates the tax revenues to decrease by € 385 million per annum.

(7) Under the third measure (registered under N 413/2008) individuals investing in TEs are entitled to *income tax benefits* in case of capital gains on divestures. Although the tax advantage is directly granted to the individual investors, the TEs may indirectly benefit from this measure through more investment. Germany estimates the tax revenues to decrease by € 30 million per annum.

2.2. **Beneficiaries of the measures**

(8) The beneficiaries of the three tax measures in the MoRaKG are VCCs and TEs as defined by the MoRaKG and individuals, mostly business angels, in the following way:

\[
\begin{array}{|c|c|c|}
\hline
& \text{Trade tax measure} & \text{Exemption from the prohibition on loss-carry forward} & \text{Income tax benefit} \\
\hline
\text{VCCs} & \text{Directly} & \text{Indirectly} & \text{No} \\
\hline
\end{array}
\]

\textsuperscript{2} OJ C 60, 14.3.2009, p. 9.
A VCC must be recognised as a VCC by the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin). The company may not be registered as an equity investment company (Unternehmensbeteiligungsgesellschaft) at the same time. Further criteria for qualification as a VCC are the following:

- The objective laid down in the articles of association of the VCC must be the acquisition, participation, management and sale of venture capital participations. 70% of the total assets managed by the VCC must be equity holdings in TEs.

- The VCC must have its domicile (Sitz) and its corporate management (Geschäftsleitung) in Germany.

- The basic capital (Grundkapital) of a VCC or the contributions made by its members under its memorandum or must amount to no less than € 1 million.

- A VCC must have at least two managers, who must be trustworthy and suitably qualified to manage a VCC.

A TE must be an incorporated enterprise (Kapitalgesellschaft) and fulfil the following conditions to qualify as a TE:

- It must have a registered office and centre of management in a State that is a contracting party to the Agreement on the European Economic Area;

- It must have, at the time it is acquired by a VCC, owner's equity of not more than € 20 million;

- It must have been founded not more than 10 years before the time it is acquired by a VCC;

- It must have not had, at the time it is acquired by a VCC; any securities (Wertpapiere) admitted to or traded on an organised market or an equivalent market.

The measure does not elaborate on the definition of a TE as regards the definition of firms in difficulty.

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3 Equity Investment Companies are registered by the competent supreme Federal State Authority (Oberste Landesbehörde). Permitted business under this registration are all types of private equity investments.

2.3. Trade tax

2.3.1. Background

(12) The German trade tax (Gewerbesteuer) is raised by local authorities with respect to activities carried out by a permanent establishment of a business within a community/municipality. The rationale is that those permanent establishments of companies should contribute to the cost of the local infrastructure used. Trade tax has to be paid by all undertakings, regardless of their legal status, if they are "trading" (gewerblich tätig) in the sense of trade tax and income tax law. Incorporated firms (Kapitalgesellschaften) are always considered to be trading. For partnerships (Personengesellschaft), the distinction is made on the activity: If an undertaking is a partnership and its activity is exclusively non-trading (vermögensverwaltend), it is not subject to trade tax. On the other hand, partnerships which are trading are subject to trade tax.

(13) The Federal Ministry of Finance issued a letter on the distinction between trade activities and asset management activities of venture capital funds and private equity funds (hereinafter: VCF/PEF). On the basis of this letter VCF/PEF are subject to the trade tax if their activity is considered as a trade activity. However, if they pursue only asset management, they are not subject to the trade tax. This letter of 2003 is based on a judgment of the Highest German Financial Court (BFH) of 25 July 2001. It assumes that VCF/PEF do not pursue trading activity provided that the criteria below are met:

- No use of bank loans / no acceptance of collateral
- No extensive separate organisation to manage the fund portfolio office use not more than normal to a 'large private fortune' would require
- No market exploitation using professional experience
- No public offering / trading for its own account
- No short-term investment
- No reinvestment of the proceeds of sale
- No commercial activity in portfolio companies (eigenes unternehmerisches Tätigwerden in den Protfoliogesellschaften).
- No commercial character or “commercial infection” (gewerbliche Infektion)


6 BStBl II 2001, p. 809

7 The fund may not maintain an extensive separate organisation to manage the fund portfolio. (Der Fonds darf für die Verwaltung des Fondsvermögens keine umfangreiche eigene Organisation unterhalten. Betreibt der Fonds ein eigenes Büro ist dies unzulässig wenn dies nicht das bei einem privaten Großvermögen übliche Ausmaß übersteigt.) If the fund operates a separate office and has employees, this is not harmful provided this is no more extensive than would be the case for a large private portfolio.
In substance, these criteria are intended to clarify the traditional distinction enshrined in German tax law between trading and non-trading activities for VCF/PEF. Asset management is seen as a non-trading activity. The distinction between trading and non-trading activities is very border-line and subject to numerous court decisions inter alia by the Highest German Financial Court. As a general rule, a VCF or a PEF is trading, whenever the trading of assets (only short periods between purchasing and selling assets, e.g. securities) represents a significant part of the activities.

2.3.2. Clarification on trade tax foreseen by the MoRaKG

According to the notification, Article 1 § 19 of the MoRaKG includes a 'clarification' of the letter of 2003, and allegedly there is no substantial difference between the two.

According to this provision if a VCC in the legal form of a partnership carries on only the acquisition, holding, management and sale of venture capital holdings and if it has holdings only in incorporated companies, it shall be treated for purposes of income tax as non-trading asset management activity. A VCC shall be deprived of its non-trading status especially where it engages in any of the following or similar activities:

- short-term sale of venture capital holdings and other holdings in companies having their registered office and place of management in a State that is a contracting party to the Agreement on the European Economic Area;

- transactions meaning money market instruments\(^ {10}\), transactions with bank deposits with credit institutions having their registered office in a State that is a contracting party to the Agreement on the European Economic Area; transactions with investment participations\(^ {11}\);

- advising a TE in which a VCC has a holding, granting loans and guarantees to a TE in which a VCC has a holding, taking out loans and issuing profit participation rights (Genussrechte) and bonds;

- reinvestment of proceeds from the sale of venture capital holdings and other holdings in companies having their registered office and centre of management

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8 A commercial infection, referred to as income requalification (Abfärbetheorie), would, for example, occur, if an entity which is exempted from trade tax would start an additional commercial activity, which in turn would cause a contamination and result in that the entire entity would lose its trade tax exempt status, even if the trading activity would only represent a minor part of the overall activity.

9 A trade activity is defined as an independent, lasting activity, which is exercised in a profit-seeking intention (no hobby) and may be characterized as a participation in the general economic life business (goes beyond services performed for family or friends) and furthermore is neither an agricultural or an independent activity (as a lawyer, doctor, artist or teacher). Asset administration is defined as an activity, which is characterized by the use of property in the sense of reaping the benefits from property, which is to be maintained and the exploitation of property via regroupment of investment is not decisively the main reason. The characterization as professional activity or asset management is of particular importance for investments in securities or in real estate. Where such an activity is characterised as trade income, all capital gains are taxable and the activity is also subject to trade tax. Where it is characterized as mere asset administration (Vermögensverwaltung), the income of the various sources is taxed, but a possible sale of the underlying source may be exempted from capital gains taxation (and not subject to trade tax).

10 Within the meaning of Section 48 of the Investment Act.

11 Within the meaning of Section 50 of the Investment Act.
in a State that is a contracting party to the Agreement on the European Economic Area;

– exploitation of a market using its professional experience.

(17) The acquisition and maintaining of the firm’s own business premises and of a proper business organisation shall not prevent a VCC from being considered to conduct asset management activity. The above activities under recital (15) may, however, be carried out by a subsidiary, which is wholly owned by the VCC.

2.4. Loss Carry-Forward

2.4.1. Introduction

(18) The losses incurred in a tax year by a company may normally be carried forward. This means, they may be set-off against profits in future tax years. The carry-forward of losses permits that losses will be taken into account over the life cycle of a company. However, this also permits abuse in the form of so-called "shell companies" which have ceased their activities, but are sold as their loss carry-forwards represents a real value: a purchaser of such a shell company with a loss carry-forward benefits from a setting-off of future taxable profits and thus will make a tax saving depending on the applicable tax rate.

(19) Germany has introduced Anti-Abuse measures regarding the trafficking of losses in the German Corporate Income Tax Act (hereinafter: CITAx). The Law on the Continuation of the Company tax reform of 1997 stopped the trafficking of losses in the form of shell companies. Germany tightened the Anti-Abuse measures by the Act to reform Company taxation (Unternehmenssteuerreformgesetz 2008). This rule has an impact on all changes in the direct and indirect shareholding of more than 25% within 5 years. The CITAx provides for a pro-rata deduction of losses, if within five years more than 25% of the capital, of the membership rights, of participation rights or of the right to vote directly or indirectly will transfer to an acquirer. Not used losses are not deductible at all, if within five years more than 50% of the capital or of the above rights transfers to an acquirer.

2.4.2. The MoRaKG

(20) The MoRaKG would relax the loss carry-forward rules for TEs acquired by VCCs, as it provides for a tax loss carry-forward by TEs with a significantly new ownership, which would otherwise lapse under the basic rule.

(21) According to Article 4 of the MoRaKG, in the event of a direct acquisition by a VCC of a participation in a TE, the losses of the TE continue to be deductible to the extent of the hidden reserves of the TE taxable domestic assets. The same shall apply in the event of a direct acquisition from a non-VCC of a participation in TEs from a VCC, if

– when the participation is acquired, the TE has equity of no more than € 20 million, or

– when the participation is acquired, the TE has equity of no more than € 100 million and the increase in equity in excess of € 20 million derives from annual profits in the four financial years preceding the sale;
the period between the purchase and sale of the participation in the TEs by the VCC is at least four years.

(22) Up to one fifth of the loss deductible may be deducted under the arrangements for the deduction of losses of the Income Tax Act in the year of the acquisition; in each of the following four years this figure shall increase by a further fifth of the deductible loss.

2.5. Tax benefits for individuals

2.5.1. Introduction

(23) The MoRaKG intends to encourage private investors such as business angels to invest in TE by offering a tax advantage for the profits made from their investment.

(24) According to Article 1 §20 of the MoRaKG, the capital gains on the sale of an investment in a TE shall be divided proportionally among the investors according to their participation. The resulting amount is taken into account for the income taxation of the individuals / business angels.

(25) The tax break would only materialise in case of a realised capital gain. The participation of the individual / business angel in a TE must be between 3 % and 25 % at any moment within the last 5 years with a maximum holding time of 10 years. Each individual / business angel is entitled to tax free profits of up to € 50,000 (200,000 * 0.25) per investment, which corresponds to the maximum theoretical participation of 25 %. Hence the maximum tax advantage per business angel and per investment is approximately € 22,500, according to the calculation of Germany. The tax advantage would be proportionally reduced for profits above € 800,000 per investment, and fully disappear, if the total profit reaches € 1,000,000.

3. DOUBTS EXPRESSED IN THE OPENING DECISION

(26) As described in recital (3), the Commission decided on 28 January 2009 to open a formal investigation procedure (hereinafter "opening decision"). In the opening decision the Commission expressed its preliminary view that all three measures constitute State aid.

3.1. Existence of State aid in the Trade tax measure

(27) On the basis of the comparison of the letter of 2003 and the 'clarification' in the MoRaKG, the Commission had doubts whether the German claim that MoRaKG only creates a statutory 'clarification' of the letter of 2003 is correct as it seemed that the law would provide some advantageous tax treatment for the newly created specific category of venture capital companies defined by MoRaKG as VCCs. Indeed it seemed that the 'clarification' deviates from the provisions of the letter of 2003, and may allow less limitative criteria for certain VCCs to benefit from the trade tax exemption.

(28) On the basis of these doubts the Commission noted that the trade tax measure would favour certain VCCs vis-à-vis other investment companies, which may pursue exactly the same or similar activities. Moreover, the exemption from trade tax would decrease
the estimated yearly tax revenue by about € 90 million, which may indicate that the MoRaKG does not only 'clarify' the letter of 2003.

3.2. Existence of State aid in the Loss carry-forward measure

(29) In principle Germany has not excluded that the measure on loss carry forward is selective and hence favours both TEs and VCCs. Germany claimed, however, that this is justified by the nature and logic of the German tax system. The introduction of the general restriction on the exploitation of tax losses in 2008 disadvantaged the venture capital market in a specific way. Therefore, Germany argued, the exploitation should continue to exist for this market, and thus the measure meets the criteria set out in the Notice on Business Taxation\(^\text{12}\) (hereinafter: Notice on Business Taxation).

(30) The Commission noted, however, that other investment companies (outside the VCC-definition) should not be excluded, if the measure is justified by the nature and logic of the German tax system, as non-VCCs may also invest in TE and should also benefit from the same right to exploit the losses. This is not the case, as TEs co-owned by non-VCCs can only carry over their losses, if the non-VCC has bought its participation from a VCC under the conditions described in recital (21).

(31) Germany also claimed that the measure does not affect trade between the Member States for the purposes of Article 87(1) EC Treaty, since it has an "internal objective" in compliance with the Notice on Business Taxation. It only represents an exception to a strict rule, to which normally no comparable rule is present abroad; therefore there can be no cross-border effect on competition or trade.

(32) However, the Commission noted that the beneficiaries of this measure may be involved in trading with other Member States; therefore the measure may have an effect on trade. Moreover, the point of reference by which to assess whether a tax measure grants a selective advantage to certain undertakings is the generally applicable system in the Member State concerned; the question which rules apply in other Member States is, in principle, irrelevant.

3.3. Existence of State aid in the tax benefits for individuals

(33) Germany claimed that the beneficiaries of this measure are individuals and therefore it does not constitute State aid. The measure, however, makes investments in certain companies (TEs) more appealing for investors and thus may indirectly favour certain undertakings, namely TEs\(^\text{13}\).

(34) Therefore, the Commission considered that the criteria of "advantage" and "selectivity" are met. Moreover, the implementation of the measure would decrease the estimated yearly tax revenue by about € 30 million.


\(^{13}\) The fact that a tax advantage to individuals investing in certain companies may involve aid to these companies has been confirmed by the Court, see Case C-156/98, Germany v Commission, ECR (2000), I-06857.
3.4. Compatibility with the Risk Capital Guidelines

(35) The first doubt of the Commission regarding compatibility of the measures with the Community guidelines on state aid to promote risk capital investments in small and medium-sized enterprises (hereinafter: RC Guidelines) stemmed from the fact that the RC guidelines exclude the provision of State aid in the form of risk capital to large enterprises, to firms in difficulty, as well as to firms in the shipbuilding, coal and steel industry. In the case at hand, however, the above undertakings may benefit from the measures; therefore the scope of the measures (with regards to the beneficiaries) is not defined in compliance with the RC Guidelines.

(36) In addition, according to section 4.3 of the RC Guidelines, State aid must target a specific market failure for the existence of which there is sufficient evidence. Such evidence has not been submitted by Germany.

(37) Finally, the Commission also had doubts on whether the other safeguards set by section 4 of the RC Guidelines are present. Furthermore, the Commission noted that the limitation of the tax advantage to VCC investing into incorporated enterprises appears to contradict the alleged objective of the measure, namely to promote the provision of risk capital to all companies that necessitate it. Indeed, young innovative companies in need of risk capital might take legal forms other than that of incorporated companies. Hence, young innovative companies in the form of a partnership would not benefit from the measure.

3.5. Compliance with the common market

(38) The Commission had doubts on the compliance of the measures with the common market rules. In order to qualify as a VCC, an undertaking must have its domicile (Sitz) and its corporate management in Germany. It appears that certain undertakings, in particular permanent establishments/branches and subsidiaries of the Community and the EEA companies with a domicile (Sitz) outside Germany, would not be eligible. This condition may hinder the freedom of establishment within the meaning of Article 43 of the EC-Treaty.

(39) Germany claims that companies with a domicile outside Germany may not be supervised by BaFin, and they would enjoy an unjustified competitive advantage over German VCCs. The Commission doubted that supervision of the establishments of foreign companies registered in Germany, which are de facto in competition with VCCs, could not be arranged by other means. Therefore, at that point in time, the Commission did not consider that there was a justification for excluding such undertakings from the scheme. The Commission doubted also for this reason that it could declare the relevant measures compatible with the common market.

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14 C 194, 18.08.2006, pages 2-22

15 The definition of TE in MoRaKG does not match the EU SME definition. For example, regarding the condition that a TE must have, at the time it is acquired by a VCC, owner's equity of not more than € 20 million, the Commission notes the following: the balance sheet total equals to the sum of the owner's equity and the liabilities. The liabilities normally represent a significantly higher amount than the owner's equity. Hence the € 43 million balance sheet total threshold for SMEs is easily exceeded by TEs. Furthermore, the limit of 250 on headcount and the limit of € 50 million on turnover are not included in the TE definition either.
4. THE GERMAN COMMENTS ON THE OPENING DECISION

(40) By letter dated 3 March 2009, Germany submitted its comments on the decision to initiate the procedure laid down in Article 88(2) of the EC Treaty. The comments concerned all three measures. In summary, Germany reiterated its view that those measures do not constitute state aid.

4.1. Trade tax measure

(41) Germany stressed its view that the trade tax measure does not exempt companies from trade tax. It rather clarifies the distinction between trading and asset managing activities and thus has only declaratory meaning (deklaratorische Bedeutung). The final assessment if a venture capital company is trading or asset managing would be done in line with German court rulings, which are summarised in the letter of 2003.

(42) As regards the estimated losses of € 90 Mio in tax revenue, Germany explained that it expects, after the clarification of the MoRaKG, that less 'accidental contracts' (verunglückte Vertragsgestaltungen) would occur, in which the taxes are only due because of an accidental arrangement of contracts.

4.2. Loss Carry-Forward measure

(43) Germany stressed its view that the rules on loss deduction at the level of the TE are justified through the nature and the logic of the tax system, even if investment companies outside the MoRaKG-definition would invest into TEs.

(44) Germany argued that the distinction between VCCs and other investment companies lies within the legislator's room for manoeuvre (Gestaltungsspielraum) as there are objective differences between VCCs and other investment companies. Accordingly, pursuant to point 24 of the Notice on Business Taxation, a different treatment is justified.

(45) Furthermore, VCCs are in a special situation. They typically invest in TEs with loss carry forward, and the second measure is therefore not state aid but it is a compensation for the specific disadvantages (Nachteilsausgleichsregelung) of the current system with regards to the venture capital sector.

4.3. Tax benefits for individuals

(46) First and foremost Germany considers that the tax benefit measure has no appreciable effect on the trade between Member States, in particular as the tax benefit per investor is limited to € 22.500. In addition, those rules apply equally to investments in TEs in all Member States, with no distinction between German TEs and TEs from other Member States.

(47) Germany also stresses that the direct beneficiaries are individuals, which are not covered by State aid rules. It furthermore underlines that due to the specific structure of the measure no somehow quantifiable advantage (kein irgendwie quantifizierbarer Vorteil) is granted to TEs, which in turn excludes an aid character of the measure.
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Germany describes that the tax benefit is related to the disposal of the participation in the TE (Veräußerungsvorgang), and hence has no direct link to the investment.

4.4. Infringement of the freedom of establishment

In the opinion of Germany, MoRaKG does not infringe the freedom of establishment under Article 43 of the EC Treaty, as a restriction of the freedom of establishment would be justified if the requirement of domicile afforded the only opportunity to ensure compliance with the legal conditions.

5. COMMENTS BY THIRD PARTIES

By letters dated 9 April 2009 (Bundesverband Deutscher Kapitalbeteiligungs-gesellschaften – German Private Equity and Venture Capital Association e.V. (BVG)) and 14 April (Biotechnologie-Industrie-Organisation Deutschland e.V. (BIO) and Business Angels Network Deutschland e.V. (BAND)) three interested parties submitted their comments on the opening decision.

5.1. Observations by third parties on trade tax

The BVK stated that the introduction of legal criteria in the MoRaKG for the classification of a VCC as non-trading for tax purposes does not result in a tax incentive for VCCs. On the contrary, the MoRaKG will further contribute to uncertainty in the sector.

According to BVK, the 'clarification' is not less stringent than the letter of 2003, as the Finance Committee of the Parliament took the view that the letter of 2003 also continues to apply alongside the MoRaKG\textsuperscript{16}. As a result, the general provisions made in Article 1 § 19 of the MoRaKG are to be concretised by the letter of 2003. Owing to this unsatisfactory regulatory technique, the criteria contained in the letter of 2003 also continue to apply to the VCCs. Therefore the loss in tax revenue, estimated by the Federal Government to be approximately € 90 million, is difficult to substantiate in the view of the BVK.

The BVK expressly advocates uniform general conditions for domestic and foreign private equity companies – in particular those from other European Union Member States – and their domestic and foreign investors in Germany.

BIO argues that the MoRaKG does not provide venture capital companies with preferential exemption from trade tax. The MoRaKG is intended to lay down in law the already common practice, attested by the letter of 2003, of exempting asset management funds from trade tax.

\textsuperscript{16} See the Opinion of the Bundestag Finance Committee, BT-Drucks. 16/9829, p. 5f: For the interpretation of the legal regulation, the previous order remains supplementing applicable; ("zur Auslegung der gesetzlichen Regelung bleibe deshalb der bisherige Verwaltungserlass ergänzend anwendbar").
5.2. Observations by third parties on Loss Carry-Forward

(55) The BVK is of the opinion that the German legislature should treat both domestic and foreign venture capital and private equity companies in the same way as venture capital companies within the meaning of the MoRaKG. The BVK also takes the view that this objective can be achieved only by means of uniform general legal and fiscal conditions for all private equity companies. BVK suggests a non discriminatory loss deduction for those venture capital companies which do not fall under the definition of MoRaKG. The BVK reaffirms that the prohibition on loss deduction contained in the CITTA greatly impedes the investments of venture capital and private equity companies.

(56) BIO Deutschland sees the MoRaKG as an improvement to the status quo as regards the loss carry forward. BIO concentrates on loss carry forward and finds that the targeted mitigation of a disadvantage does not constitute aid. In particular innovative SMEs are disadvantaged though the existing loss deduction rules and MoRaKG would compensate for the disadvantage (Steuerbenachteiligungsausgleichsregelung). BIO states that the MoRaKG makes it possible to distinguish capital investment companies which provide capital to the enterprise in a clear and necessary way.

5.3. Observations by third parties on tax benefits for individuals

(57) As regards the general objective of tax breaks for private investors, the BVK supports the MoRaKG. For the BVK the tax benefit measure constitutes a reasonable incentive for individuals who invest in the high-risk sector of early stage financing addressed in the MoRaKG.

(58) BAND stresses that such tax breaks for investors in young companies are common and more generous in other Member States. BAND welcomes the objective to introduce tax breaks for private investors and hence welcomes the MoRaKG. At the same time, the BAND expresses doubts whether MoRaKG has any appreciable incentive effect on the business angels, given the rather low tax advantages which only materialise after a successful exit. BAND considers that the maximum tax advantage per investor is, due to the partial income procedure (Teileinkünfteverfahren) about € 14.210 and not, as described by Germany, about € 22.500. BAND furthermore considers that the indirect aid to the TEs would in reality always be below the thresholds of the de minimis limits of € 200.000. The advantage would, if at all, only occur at the time of the exit of the investor.

(59) BIO finds that the maximum advantage granted to a private investor, which is conceivable only where specific conditions are met, is € 22.500. This amount is minimal, unconnected to the investment (resulting rather from the sale of any holdings) and therefore not transferrable to the TEs.

6. The German Comments on Observations by Third Parties

(60) By letter dated 22 May 2009 Germany reacted to the comments by interested parties.
6.1. Trade tax measure

(61) Germany notes that the BVK, while having criticised the MoRaKG, does confirm that MoRAkG does not deviate from the legal situation as regards the distinction between trading and asset management activities.

6.2. Loss Carry-Forward measure

(62) Germany notes that the suggestion of the BVK to extend the measure to the entire private equity sector would cause unjustified windfall profits (ungerechtfertigte Mitnahmeeffekte). In order to clearly target the measure, Germany chose the necessary differentiation.

(63) Germany underlines that the argumentation used by BIO supports its view that MoRaKG is a coherent differentiation based on objective criteria in order to avoid an excessive loss deduction (Verlustausnutzung).

6.3. Tax benefit for individuals

(64) Germany sees the comments by the interested parties as a support for its view, that the indirect and low aid, with a profit oriented objective and the TEs located anywhere in the EU do not constitute State aid.

7. ASSESSMENT

7.1. Presence of State aid

7.1.1. Trade tax measure

(65) The formal investigation procedure has not dispelled the doubts of the Commission concerning the alleged legal 'clarification' in the MoRaKG of the letter of 2003 with regard to the exemption from the liability for trade tax.

(66) Germany is of the view that this measure will imply a loss of tax revenues of € 90 million per annum. It explains this loss by less "faulty contractual arrangements". The Commission does not find this justification convincing. It is indeed hard to believe that venture capital companies have such a bad knowledge of the tax law and cannot avoid such "faulty contractual arrangements" and the corresponding tax liability. Furthermore, third parties tend to confirm the Commission view as BVK finds that MoRaKG will further contribute to uncertainty in the sector.

(67) In any case, the Commission notes that it is undisputed that the measure would imply a loss of State resources compared to the previous existing situation that would otherwise have accrued to the State. The Commission finds therefore the measure is granted through State resources.

(68) Regardless of the question of the conformity of the 2003 letter with the nature and general scheme of the German tax system which does not arise in the present case, in the opening decision the Commission noted that the MoRaKG may deviate from the letter as:
- VCCs may find investors (initiators) through marketing to a wide public, while this is excluded in the letter of 2003;

- VCCs may have offices for a 'business like' (geschäftsmässig) organisation of their activities, while the letter of 2003 prevents to have a 'substantial own organisation' and limits the number of employees and office use to what would be normal to a 'large private fortune' (privates Großvermögen);

- The commercial activity in portfolio companies of the VCCs vis-à-vis the TEs is not explicitly excluded in MoRaKG, while the letter of 2003 does not allow "commercial activity in portfolio companies" as stated in recital (13).

(69) The comments received during the formal investigation did not allow dispelling these doubts. Hence the Commission must conclude that MoRaKG enlarges the potential group of beneficiaries exempted from trade tax liability as some VCCs may qualify as not liable for trade tax, which would be liable according to the letter of 2003. Therefore, the measure under examination grants a tax advantage to certain VCCs, in that it allows them to carry out certain activities and still enjoy the tax liability exemption, as compared to all other VCF/PEF, which are only subject to the letter of 2003. Therefore if they carried out those activities they would lose the tax liability exemption.

(70) Moreover, the measure grants a selective advantage only to certain VCCs falling under the scope of the MoRaKG as compared to VCF/PEF. Indeed, a VCC benefits from this measure only if it complies with the definition set by the MoRaKG. Hence VCF/PEF having less than 70% of the total assets in equity holding in TEs may not benefit from the measure even if they carry out substantially identical activities. The same reasoning holds for VCF/PEF which do not have both their domicile and corporate management in Germany. As a result, VCF/PEF that only have a permanent establishment in Germany cannot benefit from the MoRaKG, even if they carry out exactly the same activities as VCCs.

(71) These limited numbers of companies are relieved by means of State resources of a part of their operating costs (namely liability for a certain tax), which they would normally have to bear under the current legal framework. The beneficiaries of this advantage are essentially active in the provision of private equity and venture capital in competition with other providers established in Germany and abroad. Consequently, this fiscal measure, by increasing the financial means available to them to carry out their activity, strengthens their position in relation to their competitors in the Community. Therefore the aid is capable of affecting competition and trade between Member States.

(72) The Commission comes therefore to the conclusion that the notified trade tax liability measure constitutes State aid to certain VCCs within the meaning of Article 87 (1) of the EC Treaty.

7.1.2. Loss deduction

(73) As stated above under point 4.2, Germany in principle agrees that the re-establishment of the loss carry forward for VCCs investing in TEs is selective and favours both, TEs and VCCs. Germany, however, argues that VCCs and the TEs were demarcated in an acceptable and practical manner and their distinction is justified by objective differences between taxable legal persons in compliance with point 24 of the Notice on Business Taxation (which states that some differentiations in the tax system may be
justified by objective differences between taxpayers), because the introduction of the general restrictions on the exploitation of tax losses in 2008 disadvantaged the venture capital market in a specific way.

(74) First, the Commission observes that it is undisputed that the measure implies a loss of State resources for the State. Therefore it is granted through State resources. This tax loss benefits TEs and VCCs since they are the beneficiary of this measure. The more generous terms for tax deduction of loss carry forward, established for TEs if they are acquired by VCCs, constitutes an economic advantage for these two sets of companies as it allows them to realise tax savings. Indeed, the TE benefits in the first instance from the loss carry-forward since it is able to set off a loss and thus pays less tax that would otherwise be excluded by the so-called anti-abuse rule. Then the VCC is a fairly immediate beneficiary in the sense that any other purchaser would not be able to benefit from the additional set-off.

(75) As the tax saving is essentially only available if VCCs invest in TEs, the measures favours TEs also indirectly. Indeed, it constitutes an incentive for VCCs to invest in TEs rather than other companies that may be targeted by venture capital investors on the basis of purely economic considerations. In turn TEs are capable of receiving risk capital in amount and conditions different from what would have been the case in the absence of the measure. The measure is thus capable of indirectly reinforcing the capital base of TEs.

(76) It seems moreover appropriate to reject Germany's argument according to which even if it cannot be excluded that the definition of TE covers firms in difficulty, this measure should not represents any advantage for such companies. Indeed, Germany argues that if a TE gets into difficulties, it will not make profits that would offset its losses and could be taxed. So it is irrelevant whether or not such a firm can exploit the losses of earlier periods. As a result, MoRaKG does not offer any advantage to firms in difficulty as defined by Community law, according to Germany. The Commission finds that this argument is not plausible as an acquirer of a firm in difficulty or of a "shell company" may in fact be particularly interested in the loss carry forward for tax purposes.

(77) These advantages are capable of affecting trade and competition. As regards VCCs the Commission makes reference to the assessment of this requirement carried out with regard to the trade tax exemption (see recital (71)). With regard to TEs, the Commission notes that these companies can be active in any economic sector, including those that are or might be subject to intra-Community trade. Therefore, the economic advantage granted to them is apt to affect competition and trade between Member States.

(78) Second, the Commission notes that it is undisputed that the measure is selective.

(79) Third, the Commission finds that Germany has not succeeded in demonstrating that the measure complies with the nature and general scheme of the tax system. Indeed, even if it were true that the venture capital market is particularly affected by the restrictions on exploitation of tax losses and thus a specific treatment would be justified, the Commission finds that the distinction drawn up by Germany between taxpayers is not justified by this reasoning, since not the whole venture capital sector is exempted from the prohibition on loss carry forward. Assuming that the presumptions of the German reasoning are correct, there is no objective reason for non-VCCs not to benefit from the measure when they invest into the same TEs.
However, non-VCCs only benefit from the measure in the rare case if it acquires a participation in a TE from a VCC. These views are also confirmed by the comments of the BVK as stated under point 5.2.

Moreover, the measure does not seem to comply with the nature and general scheme of the German tax system as it is not demonstrated why the VCC would be particularly affected by the restrictions on the exploitation of tax losses when they invest in TEs and not when they carry out the same activity of providing capital to other companies such as partnerships which might as well have difficulties in accessing risk capital (notably young innovative companies).

The Commission notes furthermore, that when Germany tightened the Anti-Abuse measures on loss carry forward by the Act to reform Company taxation in 2008, as stated in point 2.4.1, it set out the new general tax regulation of this matter. These Anti-Abuse measures would be now partly reversed, by allowing more generous terms for tax deduction of loss carry forward for a selected group of companies, which does not seem to be justified by the nature and logic of the tax system in force since 2008.

The Commission comes therefore to the conclusion that the notified measure on loss carry forward constitutes State aid to TEs and also to VCCs within the meaning of Article 87 (1) of the EC Treaty.

7.1.3. Tax benefits for private investors

As stated above under point 4.3, Germany claims that the beneficiaries are individuals and that therefore the measure does not constitute State aid at all. Alternatively, Germany claims that the measure has no verifiable and quantifiable advantage for TEs and hence has no impact on the price of the shares. The tax amount saved by the private investors is rather small and granted only in case of a successful exit by the investor. Therefore, as Germany argues, the measure is likely to have only a limited incentive effect for the individuals to invest in TEs. Hence it would also have a limited distortive effect on the competition between TEs and non-TEs.

As it is stated under point 2.1 above this measure implies a loss of State resources quantified by Germany in € 30 million per annum. It is therefore granted through State resources.

The measure in question provides individuals with tax incentives to invest into a selected group of enterprises (i.e. TEs) rather than other companies that may be targeted by venture capital investors on the basis of purely economic considerations. In turn TEs are capable of receiving risk capital in amount and conditions different from what would have been the case in the absence of the measure and under normal market conditions. The measure is thus capable of indirectly reinforcing the capital base of TEs. This analysis holds even if the fiscal advantage granted to investors is contingent on future profits and the amount is rather limited as underlined by Germany and third parties. Indeed, because of its nature it is extremely difficult to precisely quantify the advantage that TEs will receive ex ante. As a consequence it is impossible to conclude that the aid granted to the TEs will always be de minimis.

17 It is extremely difficult to establish ex ante the difference between the amount/condition at which capital would have been available in the absence of the measure and the amount/conditions brought about by the measure.
Moreover, the fact that a tax advantage to individuals investing in certain companies may involve aid to these companies has been confirmed by the Court\(^{18}\) regardless of the magnitude of such advantage to individuals.

(86) Therefore, the Commission concludes that the income tax benefit measure is selective and favours limited numbers of companies by procuring them a better access to risk capital compared to the conditions normally available in the market. This advantage is granted through State resources because it is precisely the loss of tax revenues that modifies the market incentive for private individuals to provide capital to TEs rather than to other enterprises that would have been targeted on the basis of the prospects of return on the investment that they offer.

(87) As regards the possibility of this aid to affect competition and trade between Member States the Commission makes reference to recital (77) above.

(88) The Commission comes therefore to the conclusion that the notified income tax benefit measure constitutes State aid to TEs within the meaning of Article 87 (1) of the EC Treaty.

7.2. **Compatibility with the State aid rules**

7.2.1. **Notification of the measure**

(89) By notifying the MoRaKG law before implementing it, the German authorities have fulfilled their obligations under Article 88(3) of the EC Treaty. Given that all the measures in the MoRaKG have the common objective of supporting the provision of private venture capital to companies, the Commission has analysed their compatibility in accordance with the rules established in the RC Guidelines.

(90) The Commission has also assessed the applicability of other State aid frameworks and regulations to the measures at hand, namely the Community Framework for State aid for Research and Development and Innovation\(^{19}\), the Commission Regulation (EC) No 800/2008 of 6 August 2008 declaring certain categories of aid compatible with the common market in application of Article 87 and 88 of the Treaty (General block exemption Regulation)\(^{20}\) (hereinafter: GBER) and the Commission Regulation (EC) No 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to de minimis aid\(^{21}\). Unlike the measures examined these frameworks, regulations exclude firms in difficulty and firms in the shipbuilding, coal and steel industry and/or are limited to SMEs. In the light of the above the Commission is of the opinion that the scopes of these frameworks, regulations exclude their applicability to the notified measures.

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\(^{18}\) Case C-156/98, Germany v Commission, ECR (2000), I-06857, point 64: "As a preliminary point, it should be borne in mind that the aid scheme in issue must be regarded as granting operating aid to the recipient undertakings ...".


7.2.2. Trade tax measure

(91) As stated above under point 7.1.1, the trade tax measure constitutes State aid to VCCs. This measure, however, does not explicitly provide the VCCs with incentives to undertake risk capital investments, but only allows VCCs to dispose of greater financial resources that they can use for any purpose (i.e. increased benefits distribution to their partners).

(92) Unlike the present measure, the RC Guidelines exclude the provision of State aid in the form of risk capital to large enterprises, to firms in difficulty, firms in the shipbuilding, coal and steel industry. The Trade tax measure may, however, benefit such undertakings, especially large enterprises. Therefore, the scope of this measure is not in compliance with the Guidelines.

(93) The measure cannot be considered to be compatible under Chapter 4 of the RC Guidelines because the specific conditions for the application of this chapter are not fulfilled. For instance, Chapter 4 requires that the maximum level of investment tranches may not exceed € 1.5 million per beneficiary over 12 months. The measure examined does not contain such limitation. Moreover, the RC Guidelines also requires that the measure is restricted to provide financing up to the expansion stage for small or up to the early stage for medium-sized enterprises. These provisions are not met, because TEs can be large undertakings.

(94) The measure does not comply with the cumulation and reporting requirements listed in point 6 and 7.1 of the RC Guidelines.

(95) Finally, the Commission is not in a position to assess the measure under chapter 5 of the RC Guidelines. Indeed, according to the RC Guidelines, State aid must target a specific market failure for the existence of which there is sufficient evidence. Germany has not submitted any evidence that TEs are affected by a particular market failure.

(96) Therefore the Commission concludes that the trade tax measure is not compatible with the Common market.

7.2.3. Loss deduction

(97) The Commission has concluded above in point 7.1.2 that the measure on loss carry forward constitutes State aid at the level of VCCs and at the level of TEs. The form of aid is a "fiscal incentive" according to section 4.2 (d) of the RC Guidelines.

(98) For the same reasons highlighted above in points (92), (93), (94) and (95) the Commission cannot consider the present measure as compatible with the common market as it does not meet the exclusionary criteria of point 2.1 of the RC Guidelines and the cumulation and reporting requirements listed in point 6 and 7.1, nor the conditions listed in chapter 4 of the same Guidelines and neither is there any evidence of a particular market failure affecting TEs and VCCs that would allow the Commission to start a detailed assessment of these measures under chapter 5 of the RC Guidelines.

(99) The purchase of existing shares (replacement capital) in a TE is not excluded in this measure. Replacement finance, however, is not allowed by definition of venture capital in the RC Guidelines.
Furthermore, the Commission notes that the limitation of the tax advantage to VCC investing into incorporated enterprises appears to contradict the alleged objective of the measure, namely to promote risk capital. Indeed, young innovative companies in need of risk capital might take legal forms other than that of incorporated companies. Hence, young innovative companies in the form of a partnership would not benefit from the measure.

Therefore, the Commission concludes that measure on loss carry forward is not compatible with the common market.

**7.2.4. Tax benefits for private investors**

The Commission has concluded above in point 7.1.3 that the income tax benefit measure constitutes indirect State aid at the level of TEs. The measure will have an incentive effect on the investment decisions of individuals to invest in TEs, it may hence favour risk capital investments pursuant to point 4.2 (d) of the RC Guidelines.

For the same reasons highlighted above in points (92), (93), (94) and (95) the Commission cannot consider the present measure as compatible with the common market as it does not meet the exclusionary criteria of point 2.1 of the RC Guidelines and the cumulation and reporting requirements listed in point 6 and 7.1, nor the conditions listed in chapter 4 of the same Guidelines and neither is there any evidence of a particular market failure affecting TEs and VCC that would allow the Commission to start a detailed assessment of these measures under chapter 5 of the RC Guidelines.

Therefore, the Commission concludes that the income tax benefit measure as it stands cannot be considered compatible with the Common market on the basis of the RC Guidelines. However, the measure has limited distortive effect on the competition between TEs and non-TEs given that the incentive granted to individual for providing capital in favour of TEs is rather limited and thus presumably the advantage granted to TE will also be limited. On the other hand the measure is capable of having a general positive effect in the sense of stimulating the provision of risk capital to companies which may be in need of risk capital, on the basis of a proper economic assessment. Indeed, private investors will select target companies on the basis of the prospect of making a return on their investment. Therefore, the Commission finds that the measure may be adjusted to the requirements of the RC Guidelines by ensuring that the conditions in Article 3 below are met.

**7.3. Compliance with the rules on the common market**

With regard to the Trade tax measure and the Loss carry-forward measure, where the beneficiaries may be VCCs, there are discrepancies with the common market rules especially with regard to the freedom of establishment within the meaning of Article 43 of the EC-Treaty, as mentioned in point 3.5 above.

Germany explains that the MoRaKG contains detailed rules relating to the structure and business activity of the VCCs. These include in particular regulations concerning the type of transactions and investment policy of VCCs, the question of their integration into consolidated structures and the minimum denomination of investments in such companies. These regulations apply to all VCCs. In the case of German permanent establishments of foreign investment companies, it is not possible to guarantee that the
entire company will adhere to the regulations. Merely limited recognition of the German permanent establishment would allow for the possibility of the rules being undermined and therefore, de facto, being invalidated. Every financial market regulator monitors the undertakings within its own area of responsibility according to its own national regulations, a significant proportion of which are harmonised with EU law. In the field of venture capital financing, however, the supervisory regulations are not harmonised with EU law in this way.

(107) The doubts of the Commission have not been dispelled. First, EC and EEA companies with a domicile (Sitz) outside Germany and a permanent establishment in Germany should in principle be eligible where they can show that they fulfil the conditions set out in the aid schemes and the rules relating to the structure and business activity of the VCCs (assuming their compatibility with the Treaty). The argument that BaFin is not in a position to supervise these companies neither implies necessarily that they enjoy a competitive advantage over companies established in Germany nor that they do not comply de facto with the conditions set out in the aid schemes and the rules relating to the structure and business activity of the VCCs. Therefore this argument is not per se sufficient to derogate from a fundamental rule of the Treaty.

(108) In summary, it appears that Germany could achieve the same objective (assuming it is acceptable under the Treaty), with less discriminating means. Hence compliance with the conditions set out in the aid schemes could be verified, for instance through a voluntary submission to an examination by the BaFin, through confirmations by the foreign supervisory authority or through independent audited reports. In summary, Germany should give foreign companies with a permanent establishment in Germany the possibility to prove that they comply with the conditions set out in the aid schemes and the rules relating to the structure and business activity of the VCCs.

(109) Therefore, the Commission finds that the Trade tax measure and the Loss carry-forward measure are not compatible with the Common market because they infringe the freedom of establishment within the meaning of Article 43 of the EC-Treaty.

8. CONCLUSION

(110) In consequence, the Commission considers that the aid measure on trade tax liability for VCCs is not compatible with the EC Treaty.

(111) Furthermore, the Commission considers that the aid measure on loss carry forward for TEs acquired by VCCs is not compatible with the EC Treaty.

(112) Finally, the Commission considers that the measure on tax benefits for private investors can be made compatible with the EC Treaty subject to certain conditions listed below in Article 3.

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22 For instance in State aid N 629/2007 the French authorities provided for the possibility to grant aid also to foreign investment structures equivalent to the French based structures targeted by the aid examined in that case. To the same effect see State aid case C36/2009.
HAS ADOPTED THIS DECISION:

Article 1

The State aid schemes, which Germany is planning to implement, provided for by Article 1 Section 19 and Article 4 of the Law to modernise the general conditions for capital investments (MoRaKG), is incompatible with the common market. This State aid schemes may accordingly not be implemented.

Article 2

The State aid scheme, which Germany is planning to implement, provided for by Article 1 Section 20 of the MoRaKG, is compatible with the common market, subject to the conditions set out in Article 3.

Article 3

The State aid scheme as regards Article 1 Section 20 of the MoRaKG shall be adapted so that the following conditions are met:

- the definition of target enterprises shall be limited to small and medium sized enterprises (SMEs) as defined in Annex I of the General block exemption Regulation\textsuperscript{23};

- the definition of target enterprises shall exclude companies in difficulties and companies from the shipbuilding, coal and steel industry;

- maximum investment tranches shall not exceed EUR 1.5 million per target SME over each period of twelve months and shall be restricted to seed, start-up and expansion financing;

- Germany shall develop a mechanism to ensure that cumulation and reporting rules listed in point 6 and 7.1 of the RC Guidelines are respected;

- The purchase of existing shares (replacement capital) in a target SME shall be excluded;

- There shall be no special requirements about the legal form of the target company.

Article 4

Germany shall inform the Commission, within two months of notification of this Decision, of the measures taken to comply with it.

Article 5

This decision is addressed to Germany.

Done at Brussels, 30.09.2009

Yours faithfully,
For the Commission

Notice

If the decision contains confidential information which should not be published, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to publication of the full text of the decision. Your request specifying the relevant information should be sent by registered letter or fax to:

- Commission of the European Communities
  Competition DG, State aid Greffe
  B - 1049 Brussels
  Fax: +32-2-296.1242