Subject: State aid C 2/2009 (ex N 221/2008) – Germany
Article 1 § 19 and Article 4 of the Bill to Modernise the General Conditions for Capital Investments (MoRaKG) and
State aid C 2/2009 (ex N 413/2008) – Article 1 § 20 of the MoRaKG.

Sir,

The Commission wishes to inform Germany that, having examined the information supplied by your authorities on the measures referred to above, it has decided to initiate the procedure laid down in Article 88(2) of the EC Treaty.

1. Procedure

(1) By letter dated 30 April 2008, registered at the Commission on the same date, the German authorities notified the Commission of the above mentioned measure (N 221/2008). By letters dated 26 June and 23 October 2008 the Commission asked for additional information, which was received by letters dated 24 July and 21 November 2008, registered at the Commission on the same dates.

(2) In addition, by letter dated 22 August 2008, registered at the Commission on the same date, the German authorities notified the Commission of the above mentioned other measure (N 413/2008), which has been subsequently incorporated in the Gesetz zur Modernisierung der Rahmenbedingungen für Kapitalbeteiligungen (hereinafter: MoRaKG). The German authorities initiated a meeting with the Commission that took

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place on 9 October, and submitted additional information by letter dated 19 November 2008.

(3) Since the German authorities are of the opinion that both measures do not constitute state aid, they notified them in order to obtain legal certainty on this matter.

2. DESCRIPTION

2.1 Objective of the measures

(4) The German authorities have submitted two notifications including three tax measures and two definitions of beneficiaries. These are incorporated in the MoRaKG and have the common objective of supporting the provision of private venture capital to young, medium-sized companies (mittelständische Unternehmen).

(5) The objective of measure N 221/2008 is to facilitate the provision of risk capital to young, medium-sized companies, defined as "target enterprises" (hereinafter: TE) by providing tax advantages to venture capital companies (hereinafter: VCC) in the form of exemption from trade tax (Gewerbesteuer) and allowing such VCCs to deduct losses occurred in TEs.

(6) Under measure N 413/2008 individuals investing into TEs are entitled to income tax benefits. Although the tax advantage is directly granted to the individual investors, the TEs may indirectly benefit from this measure through more investment.

2.2 Legal basis

(7) The legal basis of the measures is the MoRaKG, which includes a special act, namely the Wagniskapitalbeteiligungs gesetz (Article 1 of the MoRaKG), which includes the definitions for TEs and VCCs and clarifications for trade tax purposes and the tax benefits for individuals. MoRaKG also includes amendments to the Körperschaftsteuergesetz (Article 4 of the MoRaKG), which include inter alia the loss deduction. In particular,

– Article 1 § 19 of the MoRaKG contains provisions for the exemption from trade tax;

– Article 1 § 20 of the MoRaKG contains provisions for tax advantage to individuals;

– Article 4 of the MoRaKG contains provisions for loss deduction.

2.3 Budget, duration, instruments

(8) The form of aid is provision of tax advantages to VCCs through exemption from trade tax and allowing such VCCs to deduct losses occurred in TEs, and the provision of income tax benefits to individuals investing into TEs.

(9) Due to the implementation of the measures Germany estimates the yearly tax revenues to decrease by € 90 million as far as trade tax is concerned, by € 385 million as far as the loss deduction is concerned. As far as the implementation of the tax advantage to individual investors is concerned, Germany estimates the tax revenues to decrease by
€ 30 million. All these estimations reflect the long-term effects of the measures on the annual public tax income.

(10) The expiry of MoRaKG is not defined. However, Germany intends to evaluate the measures during its implementation. The entry into force of the measures is contingent upon the Commission's approval.

2.4 Beneficiaries of the measures

(11) A venture capital company must be recognised as a VCC by the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungs-aufsicht – 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 objective laid down in the articles of association of the VCC must be the acquisition, participation, management and sale of venture capital participations.

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

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

– A venture capital firm must have at least two managers, who must be trustworthy and suitably qualified to manage a VCC.

(12) A TE must be an incorporated enterprise (Kapitalgesellschaft). Further conditions for qualification as a TE:

– 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.

2.5 Measure 1: Exemption from trade tax

(13) The trade tax (Gewerbesteuer) is raised by local authorities with respect to activities carried out by an establishment of a business in the area of a commune. Trade tax has to be paid by all undertakings, regardless of their legal status, if they are trading (gewerblich tätig). However, if an undertaking is a non-incorporated firm and its activity is only non-trading (vermögensverwaltend) it is for trade tax purposes

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1 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.
"transparent" and will not have to pay the trade tax as a general measure. A letter\(^2\) of the Ministry of Finance (hereinafter: the letter of the Minister of Finance) gives detailed guidance on the trade tax exemption of non incorporated asset managing enterprises from trade tax.

(14) According to Germany, this guidance is "clarified" in MoRaKG specifically for VCC. The MoRaKG classifies the activity of a VCC as non–trading if the following conditions are fulfilled:

– The VCC has the legal form of a non-incorporated firm;
– Investments have to be made in eligible TEs defined by MoRaKG;
– VCCs may only pursue activities that the Act defines as main activities: the acquisition, participation, management and sale of venture capital participations;
– VCCs may have participations only in incorporated enterprises.

2.6 Measure 2: Loss Deduction

(15) The German company taxation system aims at closing undesirable loopholes in the taxation system. Forming part of this general goal, the possibility to purchase losses is excluded to avoid that investors could benefit from various legal opportunities to deduct losses from their otherwise taxable income\(^3\).

(16) However, in the event of a direct acquisition of a participation in a TE, the losses continue to be deductible by a VCC to the extent of the undisclosed reserves of the TE's taxable domestic assets. The same shall apply in the event of a direct acquisition by a non-VCC of a participation in TEs of 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.

(17) The time between the purchase and sale of the participation in the TEs by the VCC has to be at least four years.

2.7 Measure 3: Tax benefit for individuals

(18) According to the measure, the first 200,000 € of profits from selling an investment in a TE shall not be taken into account for the income taxation of individual investors. The

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\(^3\) Therefore the Corporation Tax Act would prohibit the deduction of losses from the date of acquisition, if within five years more than 25 per cent of the capital, of the membership rights, of participation rights or of the right to vote will transfer to an acquirer. Not used losses are not deductible at all, if within five years more than 50 per cent of the capital or of the above rights transfers to an acquirer.
tax advantage would proportionally reduce and finally disappear, if the total profits exceed € 1 Million. One TE may benefit from several private investments.

3. **ASSessment**

3.1 **Presence of State aid within the meaning of Article 87(1) of the EC Treaty**

(19) Germany notified the measures for legal certainty and claims that the MoRaKG does not comprise State aid. Regarding all measures, it is clear from point 2.3 of this decision that they will lead to a loss of tax income for the German authorities and thus are financed by State resources. The Commission will furthermore assess the presence of the other criteria of Article 87(1) for each measure:

3.1.1 **Measure 1: Exemption from trade tax**

(20) The first question is whether this measure benefits certain undertakings ("advantage" and "selectivity"). Regarding this point, the Commission notes that the letter of the Minister of Finance of 20 November 2003 referred to in point 13 provides general guidance regarding the conditions under which investment companies can be considered as non-trading and hence to benefit from the trade tax exemption. The German authorities claim that MoRaKG does not provide for any trade tax exemptions; in their opinion, it only creates a statutory clarification of the letter with respect to VCCs. However it seems that the clarification deviates from the provisions of the letter of the Minister of Finance, and allows less limitative criteria for VCCs to benefit from the tax exemption. In particular, the Commission notes the following:

1.1. VCCs may find investors through marketing to a wide public, while this is excluded in the letter;

1.2. VCCs may have offices for a 'business like' (geschäftsmässig) organisation of their activities, while the letter 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);

1.3. The 'active management' of the VCCs vis-à-vis the TEIs is not explicitly excluded, while the letter only allows for 'consulting'.

(21) Thus, the measure may favour a limited group of undertakings, namely VCCs, vis-à-vis other investment companies. Moreover, it may indirectly benefit another limited group of undertakings, i.e. TEIs.

(22) Consequently, the measure may also have an effect on trade between Member States and distort competition, since it may put VCCs and TEIs in a more advantageous position in comparison to their competitors in other Member States than they would have been in the absence of the measure.

(23) Moreover, the exemption from trade tax will provide an estimated yearly advantage of about € 90 million to VCCs, which raises question on the alleged mere "clarification" of the letter of the Minister of Finance.
3.1.2 **Measure 2: Loss Deduction**

(24) In principle Germany agrees that granting VCCs investing in TEs the right to deduct losses is selective and hence favours both TEs and VCCs. Germany claims, however, that this is justified by the nature and logic of the German tax system. By the introduction of the general restriction on the exploitation of tax losses, the venture capital market would be affected in a specific way. Therefore the exploitation should continue to exist for this market, and thus the measure meets the criteria set out in the Notice on Business Taxation. The Commission notes, however, that it seems, that other investment companies (outside the VCC-definition) which may also invest in TE and should, on the basis of the argument, benefit from the same measure are excluded. This is one reason for the Commission to doubt whether the measure is genuinely justified by the nature and logic of the German tax system.

(25) Germany also claims 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 is present abroad; therefore there can be no cross-border affect on competition or trade. However, the Commission notes 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 an undertaking receives an advantage in the sense of the state aid rules is the generally applicable system in the Member State concerned; the question which rules apply in other Member States is, in principle, irrelevant.

(26) The right to deduct losses thus appears to favour VCCs vis à vis other investment companies, which do not have that right. Furthermore, it indirectly also appears to favour TEs in that it attracts investments in them. Therefore, the criteria of "advantage" and "selectivity" appear to be met. Moreover, the loss deduction will provide an estimated yearly advantage of about € 385 million to a number of companies active in sectors in which there is trade between Member States. Those sectors are, regarding the VCCs, the venture capital market, and, regarding the TEs, the sector of the economy in which that particular TE operates. Therefore, it is likely that implementation of the measure would have an effect on trade between Member States and that it would distort competition.

3.1.3 **Measure 3: Tax benefit for individuals**

(27) Regarding the measure, by which individuals investing into TEs are entitled to tax benefits, Germany claims that the beneficiaries are individuals and therefore the measure does not constitute State aid. This measure however makes investments in certain companies (TEs) more appealing for investors and thus may indirectly favour certain undertakings, namely TEs\(^5\). Therefore, the criteria of "advantage" and "selectivity" appear to be met. Moreover, the total yearly advantage to TEs due to the


\(^5\) 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.
measure may amount to around € 30 million. Also, as explained in the previous paragraph, it is likely that at least some of the TEs are active in sectors in which there is trade between Member States. Therefore, it is likely that implementation of the measure would have an effect on trade between Member States and that it would distort competition.

3.2 Compatibility with the Risk Capital Guidelines

(28) In the case at hand fiscal advantages are granted to certain investors (VCCs) with the view to attracting investments in certain companies (TEs). The objective of the measures is to facilitate the provision of risk capital to young, medium-sized companies. Moreover, the form of aid is a "fiscal incentive" within the meaning of section 4.2 (d) of the Risk Capital Guidelines6 (hereinafter: RC Guidelines). Therefore the measures are assessed under the RC Guidelines. As it is often the case with risk capital aid measures, there may be aid at different levels: in most cases a direct aid to the investment companies (fiscal advantage at the present case) and an indirect aid to the companies invested in (investments attracted).

(29) The first doubt of the Commission regarding compatibility of the measures with the RC guidelines stems from the fact that those guidelines exclude the provision of State aid in the form of risk capital to large enterprises7 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 measure, therefore the scope of the measure (the beneficiaries) is not defined in compliance with the RC Guidelines.

(30) 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.

(31) Finally, the Commission also has doubts on whether the other safeguards set by section 4 of the RC Guidelines are present. The Commission recalls that those safeguards aim to ensure that the aid to the companies invested in is limited so that the Commission can consider that the incentive effect, the necessity and proportionality of aid are present and that the overall balance therefore is positive. These limitations concern the maximum level of investment tranches, which may not exceed € 1.5 million per TE over 12 months, the restriction to provide financing up to the expansion stage for small enterprise or up to the early stage for medium-sized enterprises, and the prevalence of equity and quasi-equity. At this point in time, it would appear that the aid scheme does not contain such limitations. 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, non-incorporated young innovative companies would not benefit from the measure.

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7 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.
3.3 Compliance with the common market

(32) Finally, since 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 German branches and subsidiaries of EC and EEA companies, would not be eligible. This condition may hinder the freedom of establishment within the meaning of Article 43 of the EC-Treaty. Germany claims that companies with a legal domicile outside Germany may not be supervised by BaFin, and they would enjoy an unjustified competitive advantage over German VCCs. It seems, however, that supervision of the establishments of foreign companies registered in Germany, which are de facto in competition with VCCs, can be arranged. Therefore, at this point in time, the Commission does not consider that there is a justification for excluding such undertakings from the scheme. It therefore doubts, also for this reason, whether it can declare the relevant measures compatible with the common market.

4. Decision

(33) In the light of the foregoing considerations, the Commission, acting under the procedure laid down in Article 88(2) of the EC Treaty, requests Germany to submit its comments and to provide all such information as may help to assess the aid/measure, within one month of the date of receipt of this letter. It requests your authorities to forward a copy of this letter to the potential recipient of the aid immediately.

(34) The Commission wishes to remind Germany that Article 88(3) of the EC Treaty has suspensory effect, and would draw your attention to Article 14 of Council Regulation (EC) No 659/1999, which provides that all unlawful aid may be recovered from the recipient.

(35) The Commission warns Germany that it will inform interested parties by publishing this letter and a meaningful summary of it in the Official Journal of the European Union. It will also inform interested parties in the EFTA countries which are signatories to the EEA Agreement, by publication of a notice in the EEA Supplement to the Official Journal of the European Union and will inform the EFTA Surveillance Authority by sending a copy of this letter. All such interested parties will be invited to submit their comments within one month of the date of such publication.

If this letter 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 this letter. Your request specifying the relevant information should be sent by registered letter or fax to:

European Commission
Directorate-General for Competition
State Aid Greffe
B-1049 Brussels
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Yours faithfully,
For the Commission

Neelie Kroes
Member of the Commission