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German Tax and Legal News

EGC rules exception to change-in-ownership rule qualifies as unlawful state aid

The EU General Court has confirmed the decision of the European Commission that the Sanierungsklausel constitutes State aid

On 4 February 2016, the EU General Court (the first instance court for the annulment of state aid decisions issued by the European Commission) upheld the Commission's decision of 26 January 2011 that the "restructuring exception" in Germany's rules relating to the carryforward of tax losses by companies in financial difficulties constituted illegal state aid under EU law (GFKL Financial Services AG v. Commission, T-620/11, and Heitkamp BauHolding GmbH v. Commission, T-287/11). The applicants are expected to appeal the decision to the Court of Justice of the European Union (CJEU).

Germany introduced a measure in 2009 that allows certain financially ailing companies to retain their loss carryforwards even if there has been a "harmful" change in ownership of the company. Under the change-in-ownership rules, a direct or indirect share transfer of more than 25% and up to 50% (or of more than 50%) of the shares in a company that has loss carryforwards results in a pro rata (or full) forfeiture of the carryforwards. The German government did not notify the European Commission before the restructuring exception for financially troubled companies was introduced.

The applicants in the case before the General Court are German resident companies that were in financial difficulties and in need of restructuring following the financial crisis. Both companies were acquired and they both met the requirements to benefit from the restructuring exception, and this was confirmed by a binding ruling issued by the German tax authorities. The tax authorities allowed the carryforward of tax losses. On 26 January 2011, the Commission concluded that the restructuring exception constituted unlawful state aid and it ordered Germany to recover the aid granted. The German government filed an action to annul the decision of the European Commission, which was dismissed because Germany missed a procedural deadline; certain German companies that had benefited from the restructuring exception also instituted annulment actions with the General Court.

Although the General Court found that the actions were admissible, it concluded they were unjustified and it upheld the Commission's state aid decision.

Article 107(1) of the Treaty on the Functioning of the European Union (TFEU) provides that aid granted by an EU member state through any state resources, which distorts or has potential to distort competition by favoring certain undertakings and affects trade among the member states, is incompatible with the internal market. By allowing companies to reduce their tax burden through loss carryforwards, Germany is foregoing revenue, which constitutes an advantage granted through state resources. According to the General Court, the restructuring exception also confers a selective advantage on the beneficiary. The applicants had argued that the Commission should have considered the carryforward of losses to be the general rule, with the forfeiture of loss carryforwards in the event of a harmful change in ownership the exception to the rule. By granting an exception to the exception, the restructuring clause would not confer a selective advantage on the recipient, but would result in the re-application of the general rule. The General Court disagreed and confirmed the position of the European Commission that the forfeiture of losses upon a harmful change in ownership is the general rule (i.e. the system of reference). By allowing companies to retain their losses despite a harmful change in ownership, the restructuring exception creates an exception to that rule where the change in ownership concerns an undertaking in difficulty and takes place for the purpose of restructuring. The court agreed that this grants a selective advantage to companies fulfilling the conditions, since it enables them to set off losses against future profits in calculating their taxable income.

The General Court also rejected the argument that the rule is not selective because it applies to all undertakings experiencing financial difficulties. The court held that companies that are not in difficulty also may be in loss-making positions and thus would be in a comparable situation, but are unable to retain their loss carryforwards. The General Court concluded that the German corporate income tax act differentiates between loss-making companies that are healthy and those that are insolvent or over-indebted, or at risk thereof, by benefiting the latter and, for that reason, the rule must be deemed to be selective. Since the restructuring exception is based on criteria unrelated to the tax system, it cannot be justified by the nature and general scheme of the tax system. Therefore, the General Court held that the European Commission was correct in determining that the restructuring exception constitutes illegal state aid and to order recovery of aid granted.

The impact of the General Court decision is unclear, and since an appeal to the CJEU is likely, the fate of the restructuring exception will be in the hands of the CJEU. Until a CJEU decision is issued, the General Court's decision could give rise to some uncertainty for other measures that, albeit following objective and seemingly unspecific criteria, grant a tax advantage to a limited number of beneficiaries. The decisions of the EGC in cases T-219/10 (Autogrill España/Commission) and T-399/11 (Banco Santander/Commission) seemed to indicate that the court wanted to follow a rather narrow concept of selectivity, thus reducing the risk that a generic tax relief measure is considered State aid. The current decision seems to go in the opposite direction and could imply that the notion of selectivity has a rather broad meaning. As the decisions in T-219/10 and T-399/11 have already been appealed (pending cases C-20/15 P and C-21/15 P), the CJEU will have the opportunity to reconcile the different approaches as and when the CJEU will have the final word on the matter.
