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By PwC Deutschland | 03 July 2018

Exemption of loss forfeiture for troubled businesses not illicit state aid

The ECJ overturned an earlier judgment of the European General Court and held that the German tax legislation concerning the possibility of a loss-carry forward to future tax years despite a harmful share acquisition in cases of a rescue plan to save the company from insolvency – known as the salvage clause - is not illegitimate state aid.

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Background: In 2009 in a reaction to the economic crisis, the government introduced a temporary exemption (salvage clause) for share acquisitions to enable corporate recovery in Sec. 8c (1a) CTA substituting the former regulations in Sec. 8 CTA (old). Its stated objective is to facilitate the preservation of the business in a substantially unchanged form of a company in difficulties. Pursuant to that new provision, an entity may carry losses forward, even in the event of an otherwise harmful acquisition of a shareholding within the meaning of Paragraph 8c (1) CTA provided that the acquisition serves the purpose of restructuring the corporation in situations of crisis.

The European Commission saw it as indiscriminate state aid and ordered the German government to disapply it for the future and in retrospect. In practis, application of Sec. 8c (1a) CTA has been suspended pending final clarification. Following this, the government protested but lost its case before the European Court of Justice (ECJ) on a procedural point following a missed deadline. However, two taxpaying companies sued the Commission in their own names, having suffered the withdrawal of a binding ruling confirming their future entitlement to loss offset despite a “harmful” change of shareholders. In the first instance both companies lost before the European General Court which – on February 4, 2016 – confirmed the view of the Commission. As a result, one of the cases was brought before the ECJ for final clarification.

Decision of the ECJ: In its decision of 28 June 2018 the ECJ overturned the European General Court to the extent that the latter dismissed the action of the company as unfounded. According to the ECJ, the General Court erred in determining the so called reference system, i. e. the definition of the normal tax system, while answering the question whether Sec. 8c (1a) CTA is a selective measure and thus illicit state aid.

In order to classify a tax measure as selective, the ordinary or normal tax system applicable in the Member State (“the reference system”) must be identified. First, the general loss carry-forward for companies under Sec. 8 (1) CTA applies to all companies. It reflects the principle that taxpayers are taxed on the basis of their ability to pay. Second, the rule governing the forfeiture of losses in Sec. 8c (1) CTA, is an exception to that rule because it excludes the acquisition of certain shareholdings (25% or over) from the scope of the general rule. Third, the salvation clause, as set out in Article 8c (1a) CTA, excludes specific scenarios from the scope of the loss forfeiture.

As a matter of fact, the “reference system” applicable here is the unlimited loss utilization and Sec. 8c (1a) CTA – being a part thereof – is not a selective measure. The Commission and the General Court wrongly saw a difference between the “salvation clause” in Sec. 8c (1a) CTA and its predecessor, i. e. the “old” salvation clause under Sec. 8 (4) CTA (dealing with the loss restriction for “empty-shell companies”). The difference of both rules are only of formal nature since the “old” salvation clause was part of the overall loss expiry rules and Sec. 8c (1a) CTA and was only later incorporated in Sec. 8c CTA as a separate rule.

Thus, the European General Court wrongly assumed that the rule governing the forfeiture of losses is the reference framework, while excluding from that reference framework the general rule of loss carry-forward. But, as the ECJ puts it, the selectivity of a tax measure cannot be precisely assessed on the basis of a reference framework consisting of some provisions that have been artificially taken from a broader

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legislative framework. Therefore, by excluding the general rule of loss carry-forward, the European General Court has obviously defined this framework too narrowly.

Source: The ECJ case reference is C-203/16 P *Andres (faillite Heitkamp BauHolding) v Commission* judgment of June 28, 2018.

Keywords

illicit state aid, loss forfeiture, salvage clause, troubled businesses