Case C-797/19

Summary of the request for a preliminary ruling pursuant to Article 98(1) of the Rules of Procedure of the Court of Justice

Date lodged:

24 October 2019

Referring court:

Bundesfinanzhof (Germany)

Date of the decision to refer:

13 March 2019

Applicant and appellant in the appeal on a point of law:

B-GmbH

Defendant and respondent in the appeal on a point of law:

D Tax Office

Subject matter of the main proceedings

Covert distributions of profits of a limited liability company whose sole shareholder is a municipality — Failure to apply the principle that covert distributions of profits are to be added back to the company's off-balance-sheet income — Question of whether this constitutes State aid

Subject matter and legal basis of the reference

Interpretation of EU law, Article 267 TFEU

Question referred

Is Article 107(1) of the Treaty on the Functioning of the European Union to be interpreted as meaning that State aid falling within the scope of that provision exists if, under the legislation of a Member State, losses incurred (on a permanent basis) by an incorporated company as a result of an economic activity carried out without remuneration that is sufficient to covers costs are to be regarded, in

principle, as covert distributions of profits and, accordingly, must not reduce the profits of an incorporated company but, nevertheless, those legal consequences are not to be applied for permanently loss-making business activities in the case of incorporated companies in which the majority of voting rights are directly or indirectly held by legal persons governed by public law, if they carry out the activities concerned for reasons of transport, environmental, social, cultural, educational or health policy?

Provisions of EU law cited

Articles 107 and 108 TFEU

Provisions of national law cited

Körperschaftsteuergesetz (Law on corporation tax; 'the KStG'), as amended by the Jahressteuergesetz 2009 (Law on annual tax 2009), Paragraph 4(6), the second sentence of Paragraph 8(3), point 2 of the first sentence and the second sentence of Paragraph 8(7), Paragraph 34(6)

Brief summary of the facts and procedure

1 The applicant and appellant in the appeal on a point of law, a limited liability company, provides the public, the commercial, industrial and agricultural sectors, and public institutions with energy sources, water and telecommunications. In addition, it also operates and manages swimming pools, amongst other things. The city of A holds 100% of the shares in the applicant. The applicant is therefore a so-called municipal company run on its own account.

2 In 1998, the applicant took over a swimming pool from the city of A. After it had initially transferred the management of the swimming pool to a wholly owned subsidiary and the latter had ceased its management activities in respect of the swimming pool at the beginning of 2002, the applicant once again operated the swimming pool itself in the years at issue (2002 and 2003). The operation of the swimming pool generated losses in the years at issue (2002 and 2003).

3 In the context of a tax audit conducted on the premises of the applicant, the auditor took the view that the losses incurred by the applicant's operation of the swimming pool on its own account were to be regarded as covert distributions of profits ('verdeckte Gewinnausschüttungen', 'vGAs'). Although the defendant and respondent in the appeal on a point of law agreed with the auditor's findings in principle, it took the view that the aforementioned losses did not constitute vGAs, but rather non-deductible operating expenditure, and issued tax assessment notices to that effect on 15 December 2011.

4 The objections raised against this were largely unsuccessful. In the objection decision of 30 April 2013, the losses incurred by the applicant's operation of the swimming pool on its own account were taken into account as non-deductible operating expenditure in the amount of EUR … (2002) and EUR … (2003). The action subsequently brought was dismissed as unfounded by the Finanzgericht Mecklenburg-Vorpommern (Finance Court of Mecklenburg-Vorpommern, 'FC') by judgment of 22 June 2016. However, the FC considered that the losses incurred in the years at issue were vGAs in favour of the applicant's shareholder, the city of A.

5 The applicant objects to this by way of its appeal on a point of law, asserting an infringement of substantive law.

Brief summary of the basis for the reference

6 Under company law, a company can distribute its income either openly or covertly. The covert distribution of income is referred to as vGA. Such covert distributions must not reduce the profit and, pursuant to the second sentence of Paragraph 8(3) KStG, must be added (back) to the company's off-balance-sheet income. The legal concept of VGa serves to prevent a reduction in the income of the incorporated company that is caused by the shareholding relationship and is therefore not operational in nature. The second sentence of Paragraph 8(3) KStG governs only the legal consequences of vGAs, not the requirements for them. These have been developed by the case-law of the Bundesfinanzhof (Federal Finance Court, 'BFH').

7 According to the case-law of the BFH, in the case of an incorporated company, a vGA within the meaning of the second sentence of Paragraph 8(3) KStG is to be understood as meaning a reduction in assets that is caused by the shareholding relationship. In the majority of the cases decided, the case-law has assumed that the shareholding relationship is the cause if the incorporated company grants to its shareholder a pecuniary benefit which it would not have granted to a non-shareholder had it exercised the care of a reasonable and conscientious managing director.

8 The BFH has ruled, inter alia, that a vGA may also exist if an incorporated company engages in business activities without adequate remuneration which are in the private interests of its shareholders and lead to losses for the company itself.

9 For a better understanding of the case, the referring court also comments on the forms of economic activity carried out by municipalities and their possibilities for aggregating profit- and loss-making operations. The economic activity of municipalities is generally carried out in two organisational forms. First, a legal person governed by public law may pursue an economic activity via individual 'Betriebe gewerblicher Art' (commercial enterprises, 'BgAs'). In that case, although the legal person governed by public law is regarded as the taxable entity, the profits are in principle determined separately for each of their individual

BgAs. Secondly, legal persons governed by public law may make use of the legal form of an incorporated company for their economic activities. These incorporated companies are referred to as 'Eigengesellschaften' (companies run on their own account).

10 The extent to which the BgAs on the one hand and the companies run on their own account on the other hand are able to aggregate several individual operations — in particular profit-making and loss-making operations — into a single entity for determining profits for tax purposes was not legislated for prior to the entry into force of the Law on annual tax 2009, but it was the subject of several court rulings.

11 As regards the question of the calculation and taxation of profit, in the case of the BgAs, this takes place, in principle, separately for each individual operation. Therefore, the taxable profit of one BgA cannot be offset against losses of another BgA in order to reduce the tax burden. However, the case-law and the tax authorities have developed and applied 'aggregation principles', according to which, by way of exception, an organisational aggregation of several similar enterprises and several public service enterprises of a specific type (electricity, water, gas or heat) and public service and transport enterprises into a single BgA has been recognised for tax purposes because the activities carried out in them serve to realise the same concept, namely providing the population with public services. These 'aggregation principles' were legislated for in respect of BgAs by the Law on annual tax 2009 in Paragraph 4(6) KStG.

12 The question of according to which principles several different fields of commercial activity of a legal person governed by public law could be pooled together within a company run on its own account taking the legal form of an incorporated company was not assessed in a uniform manner by the case-law and tax authorities in the period prior to the Law on annual tax 2009.

13 With the Law on annual tax 2009, which amended the KStG, the legislature created, for the first time, statutory provisions for the tax treatment of permanently loss-making operations within the framework of BgAs and companies run on their own account operated by legal persons governed by public law. With regard to companies run on their own account, as a result of the provision in point 2 of the first sentence of Paragraph 8(7) KStG (new version), the legal consequences of a vGA are not to be applied in the case of incorporated companies in which the majority of voting rights are directly or indirectly held by legal persons governed by public law and for which it is demonstrated that the losses arising from permanently loss-making business activities are borne exclusively by those shareholders, simply because those incorporated companies carry out such permanently loss-making business activities. Pursuant to the second sentence of Paragraph 8(7) KStG (new version), a permanently loss-making operation exists if an economic activity is pursued for reasons pertaining to transport, environmental, social, cultural, educational and health policy without remuneration that is sufficient to cover costs. The fourth sentence of Paragraph 34(6) KStG (new

version) provides that the revised version is also applicable to the period before 2009. This provision was therefore declared to be applicable to 2002 and 2003, the years that are the subject of these proceedings.

14 In addition, Paragraph 8(9) KStG (new version) introduced a complex provision for companies run on their own account, which is intended to ensure that the privileged losses from permanently loss-making business activities are not set off against profits from lines of business which are regarded as not being 'eligible for aggregation' with the permanently loss-making business activities. This is therefore intended to create a situation for companies run on their own account that corresponds to the aggregation principles provided for in respect of BgAs in Paragraph 4(6) KStG (new version). However, unlike the provisions of Paragraph 8(7) KStG (new version), the provision in Paragraph 8(9) KStG (new version) has not been given retroactive effect by the legislature, but is applicable only as from 2009 (ninth sentence of Paragraph 34(6) KStG (new version)).

Assessment of the case on the basis of national law:

15 The losses incurred by the applicant in the years at issue constitute, in their entirety, vGAs to the City of A, as the sole shareholder, which increase the applicant's income. The fact that the shareholding relationship is the cause results from the fact that a reasonable and conscientious managing director would not refrain from demanding appropriate compensation for the losses from the shareholder. The reasonable and conscientious managing director would not be prepared to provide services which are incumbent on the sole shareholder and to accept losses for them on a permanent basis.

16 However, the off-balance-sheet adjustment of the vGAs is precluded by the revised version, which was introduced by the Law on annual tax 2009, of point 2 of the first sentence of Paragraph 8(7) in conjunction with the second sentence of Paragraph 8(7) KStG (new version), pursuant to which the legal consequences of a vGA cannot be applied to incorporated companies in which the majority of voting rights are directly or indirectly held by legal persons governed by public law, and for which it is demonstrated that the losses arising from permanently loss-making business activities are borne exclusively by those shareholders, simply because those incorporated companies carry out such permanently loss-making business activities. The requirements under point 2 of the first sentence of Paragraph 8(7) KStG are satisfied in the present case.

17 In application of point 2 of the first sentence of Paragraph 8(7) in conjunction with the second sentence of Paragraph 8(7) KStG (new version), the losses from the operation of the swimming pool can be offset against the results of the applicant's other lines of business (energy and water supply, etc.). As a result, the applicant has the possibility of offsetting the losses from the operation of the swimming pool against the its other lines of business (energy and water supply, etc.) and reducing its profits and thus its corporation tax burden accordingly in the years at issue.

Assessment on the basis of EU law:

18 Clarification is required as to whether this tax concession pursuant to point 2 of the first sentence of Paragraph 8(7) in conjunction with the second sentence of Paragraph 8(7) KStG (new version) constitutes State aid falling within the scope of Article 107(1) TFEU and is therefore subject to the prohibition on implementation laid down in Article 108(3) TFEU because it was introduced contrary to the preliminary examination procedure provided for in Article 108(3) TFEU.

19 This question is material to the decision in the present case. Should Paragraph 8(7) KStG (new version) constitute State aid within the meaning of Article 107(1) TFEU, the provision would not be applicable, pursuant to the third sentence of Article 108(3) TFEU, until a decision is reached by the Commission as to whether the tax concession is compatible with the internal market. The proceedings in the appeal on a point of law would have to be stayed until the Commission has taken that decision. If, on the other hand, the tax concession pursuant to Paragraph 8(7) KStG (new version) does not constitute prohibited aid, the decision of the FC would have to be annulled and the action allowed. The applicant's appeal on a point of law would be well-founded. The applicant would be entitled to claim the tax concession.

20 The referring court takes the view that State aid does exist in the present case. It states the following in that regard.

21 According to the settled case-law of the Court of Justice, classification of a national measure as 'State aid', within the meaning of Article 107(1) TFEU, requires the following conditions to be fulfilled (see judgment of 19 December 2018, *A-Brauerei*, C-374/17, EU:C:2018:1024, paragraph 19).

22 First, there must be an intervention by the State or through State resources, which is likely directly or indirectly to favour certain undertakings or which falls to be regarded as an economic advantage that the recipient undertaking would not have obtained under normal market conditions (judgment of 9 October 2014, *Ministerio de Defensa and Navantia*, C-522/13, EU:C:2014:2262, paragraph 21).

23 The tax concession pursuant to point 2 of the first sentence of Paragraph 8(7) in conjunction with the second sentence of Paragraph 8(7) KStG (new version) is such an advantage. According to the settled case-law of the Court of Justice, the concept of aid embraces not only positive benefits, but also measures which, in various forms, mitigate the charges which are normally included in the budget of an undertaking and which, without therefore being subsidies in the strict meaning of the word, are similar in character and have the same effect (see, for example, judgment of 3 March 2005, *Heiser*, C-172/03, EU:C:2005:130, paragraph 36). This is the case here, since Paragraph 8(7) in conjunction with the fourth sentence of Paragraph 34(6) KStG (new version) exempts the applicant, with retroactive

effect, from adjusting the ongoing operating losses arising from the operation of the swimming pool in the off-balance-sheet accounts.

24 In the present case, such an advantage would not exist if the State measure could be regarded as compensation for the fact that the applicant potentially (also) discharges public service obligations by operating the swimming pool. According to the case-law of the Court of Justice, public subsidies granted to undertakings expressly required to discharge public service obligations in order to compensate for the costs incurred in discharging those obligations do not fall within Article 107(1) TFEU (see judgment of 24 July 2003, *Altmark Trans and Regierungspräsidium Magdeburg*, C-280/00, EU:C:2003:415). In order for this to be the case, the conditions set out in the *Altmark Trans* judgment must be complied with.

25 These conditions are examined by the referring court. However, it takes the view that the second sentence of Paragraph 8(7) KStG (new version) does not comply with them. The provision merely sweepingly mentions a number of general policy reasons for giving preferential treatment to a permanently loss-making business activity. It is not possible to see a clear definition of the public service obligations, or the parameters on the basis of which the compensation is calculated to avoid it conferring an economic advantage which may favour the recipient undertaking over competing undertakings.

26 In addition, the referring court takes the view that the exclusion under Article 106(2) TFEU is also unable to rule out the existence of an advantage. Pursuant to Article 106(2) TFEU, compensation granted by the State in return for the provision of a service of general interest may, under certain conditions, be compatible with the internal market. Despite the differences between 'non-aid' pursuant to the *Altmark* ruling of the Court of Justice and the compatibility of aid pursuant to Article 106(2) TFEU, it is now possible to proceed on the basis of a largely identical legal examination of the conditions for the permissible payment of compensation (see judgment of the Court of Justice of 12 February 2008, *BUPA and Others* v *Commission*, T-289/03, EU:T:2008:29).

27 Second, Article 107(1) TFEU prohibits aid which may affect trade between Member States. In particular, when aid granted by a Member State strengthens the position of an undertaking compared with other undertakings competing in intra-Community trade, the latter must be regarded as affected by that aid (see judgment of 10 January 2006, *Cassa di Risparmio di Firenze and Others*, C-222/04, EU:C:2006:8, paragraph 141 and the case-law cited). In addition, it is not necessary that the beneficiary undertaking itself be involved in intra-Community trade.

28 These conditions are fulfilled in the present case. Refraining from adjusting the vGAs in the off-balance-sheet accounts strengthens the financial position of municipal companies run on their own account. The ability of potential competitors from other Member States to open up a swimming pool in Germany

that is similar in nature to that operated by the applicant is significantly weakened by this. Above all, however, it should be noted in this connection that refraining from adjusting the vGAs in the off-balance-sheet accounts makes it possible for ongoing losses to be offset against profits from other areas of activity (e.g. energy and water supply, etc.) when determining the company's income. These areas of activity are in any event financially strengthened by the possibility of offsetting losses. There is clearly a potential competitive situation with trans-regional private providers from these areas of activity. It would therefore be irrelevant if the operation of the swimming pool were possibly a merely local economic activity in the present case.

29 Third, the measure must confer a selective advantage on the recipient. The assessment of selectivity requires a determination whether, under a particular legal regime, a national measure is such as to favour 'certain undertakings or the production of certain goods' over other undertakings which, in the light of the objective pursued by that regime, are in a comparable factual and legal situation and who accordingly suffer different treatment that can, in essence, be classified as discriminatory (see judgments of 21 December 2016, *Commission* v *World Duty Free Group and Others*, C-20/15 P and C-21/15 P, EU:C:2016:981, paragraph 54, and *Commission* v *Aer Lingus*, C-164/15 P and C-165/15 P, EU:C:2016:990, paragraph 51).

30 In order to classify a domestic tax measure as 'selective', it is necessary to begin by identifying and examining the ordinary or 'normal' tax regime applicable in the Member State concerned. Thereafter, it must be demonstrated that the tax measure at issue is a derogation from that ordinary system, in so far as it differentiates between operators who, in the light of the objective pursued by that ordinary tax system, are in a comparable factual and legal situation (judgment of 21 December 2016, *Commission* v *World Duty Free Group and Others*, C-20/15 P and C-21/15 P, EU:C:2016:981, paragraph 57).

31 In the present case, point 2 of the first sentence of Paragraph 8(7) in conjunction with the second sentence of Paragraph 8(7) KStG (new version) deviates, in the case of companies run on their own account of a legal person governed by public law, from the general rules for adjusting vGAs in the off-balance-sheet accounts pursuant to the second sentence of Paragraph 8(3) KStG if they continue to exercise an activity on the basis of general policy considerations even though they generate losses from that activity on a permanent basis. The revised version of point 2 of the first sentence of Paragraph 8(7) in conjunction with the second sentence of Paragraph 8(7) KStG (new version) therefore provides companies run on their own account of a legal person governed by public law with the possibility of refraining from adjusting vGAs in the off-balance-sheet accounts. As a result, this therefore provides these companies with the possibility of offsetting ongoing losses against profits from other areas of activity when determining the company's income. In light of the objective pursued by the general regime of vGAs in the second sentence of Paragraph 8(3) KStG, pursuant to which reductions in assets caused by the shareholding relationship must not reduce the taxable base, all

incorporated companies, as economic operators, are in a comparable factual and legal situation. It is therefore a case of sector-specific selectivity in favour of certain companies in the area of public services.

32 Fourth, the measure must distort or threaten to distort competition. According to the case-law of the Court of Justice, in this connection, it is necessary, not to establish that competition is actually being distorted, but only to examine whether that aid is liable to distort competition (see judgment of 10 January 2006, *Cassa di Risparmio di Firenze and Others*, C-222/04, EU:C:2006:8, paragraph 140 and the case-law cited).

33 A potential distortion of competition by point 2 of the first sentence of Paragraph 8(7) in conjunction with the second sentence of Paragraph 8(7) KStG (new version) is to be assumed in the present case. In this connection, it should once again be noted that refraining from adjusting the vGAs in the off-balance-sheet accounts merely makes it possible for ongoing losses to be offset against profits from other areas of activity (e.g. energy and water supply, etc.) when determining the company's income and, as a result, for the tax burden of those profitable areas of activity to be reduced. There is clearly a potential competitive situation with trans-regional private providers from these areas of activity.

34 Furthermore, the referring court takes the view this is not a case of de minimis aid which falls within the scope of Commission Regulation (EC) No 1998/2006 of 15 December 2006 (OJ 2006 L 379, p. 5). Pursuant to that regulation, financial aid not exceeding a ceiling of EUR 200 000 over any period of three years does not constitute State aid, as it does not significantly affect competition and trade between Member States. Irrespective of the fact that it is likely that this amount will be exceeded in the present case, it is clear from the case-law of the Court of Justice that national legislation that does not lay down any limit on the amount an individual undertaking may receive is not covered, on that basis alone, by the de minimis rule laid down by the Commission Notice of 6 March 1996 (cf. judgment of 3 March 2005, *Heiser*, C-172/03, EU:C:2005:130).

35 Moreover, the referring court takes the view that the present case does not concern 'existing' aid either, but rather 'new' aid within the meaning of Article 108(3) TFEU, which is therefore subject to the prohibition on implementation laid down in the third sentence of Article 108(3) TFEU.

36 In order to clarify the question of whether the view taken by the referring court is correct in the present case and whether State aid does in fact exist in the present case, the question set out above is referred to the Court of Justice for a preliminary ruling.