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Old corporation tax rate on German branch income of non-EU companies confirmed

The Supreme Tax Court has held that the corporation tax rate on the permanent establishment income of non-EU foreign companies under the old, pre-2001 system was acceptable under community law and the double tax treaty.

Up to 2000, corporation tax was levied on a split-rate imputation system. Initially profits were taxed at 40% (in 1999 and 2000), but this burden was subsequently reduced to 30% when the after-tax profits were distributed as dividends. Because a permanent establishment cannot declare a dividend, its profits were taxed at a single rate of, in 1999 and 2000, 40%. The PE rate in earlier years was always higher than the distribution rate, but lower than the initial, retained earnings rate. In 2006, the ECJ held that these rates discriminated against foreign companies and that charging corporation tax at anything more than the distribution rate constituted an unacceptable restriction on the freedom of a foreign company to establish itself in Germany (C-253/03 *CLT-UFA*, judgment of February 23, 2006). However, this judgment only applies to branches of companies resident in other member states, given that the freedom of establishment concept only applies within the territory of the EU/EEA. A Hungarian company (Hungary was then an EU candidate country, rather than a full member state) has challenged this restriction on the grounds that it conflicts with the then valid association agreement between Hungary and the EU and with the prohibition on discrimination in the double tax treaty. The Supreme Tax Court has now rejected both arguments.

The *CLT-UFA* judgment on its own terms only applied within the EU/EEA, that is, to the income earned by the German branches of companies resident in other member states. The association agreement did not extend this application to associated and candidate countries as it only required both sides to work towards the integration and harmonisation prerequisites of full membership. It did not require immediate application of community law in the associated country unless specifically agreed. The non-discrimination clause in the double tax treaty only required that the permanent establishment income of an entity from the foreign state not be taxed at more than the equivalent income earned by a comparable domestic entity. This condition was at all times met, since the German branch rate of corporation tax was never higher than the rate charged on the earnings of a domestic corporation. The subsequent reduction to the distribution rate was not available to a branch, but this was not discriminatory as a branch could not declare a dividend. Rather, that was the prerogative of the foreign corporation and thus not a German event. Basing the rate comparison on the distribution rate as in *CLT-UFA* mixed the concept of earning income with that of its distribution and was not foreseen by the double tax treaty which accepted that different legal forms could have different tax consequences.

Supreme Tax Court judgment I R 73/11 of December 19, 2012 published on March 20, 2013.

Keywords

branch, imputation system, permanent establishment (PE), split-rate