Home State Taxation pilot project for SMEs – frequently asked questions

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(see also IP/06/11)

Is it not true that more than 95% of businesses in Europe are SMEs so that this Home State taxation scheme could have a major impact?

It is indeed true that the vast majority of businesses in the EU are covered by the EU definition of SMEs.

However, currently on average only 3% of these businesses have establishments abroad.

The share of SMEs in the corporate tax revenues of Member States is also usually very low.

Moreover, the Commission suggests if Member States wish to put a strict limit on the potential costs and risk for their tax administrations, they could restrict the application of the scheme to small companies (as opposed to small and medium) as defined in Commission recommendation 2003/361/EC i.e. companies with a number of employees less than 50.

Would the cost for tax administrations not be disproportionate for a problem that does not really exist?

No. This pilot scheme would be strictly limited both in time and scope. Therefore, the effective practical repercussions on national tax administrations concerned would also be limited. Furthermore, the Commission services will be backing up the running of the pilot scheme with appropriate research and assistance.

It is very clear that SMEs would benefit from the scheme. The SME federations have already been consulted on this idea and they are strongly supportive as they have first hand experience of the tax obstacles their members face when they want expand abroad. One should not reject an innovative idea only because it could perhaps result in a slight additional cost for administrations. It might well be the case that the future tax revenues increase on the whole, owing to improved SMEs' profits and survival rate and the expected benefits to the EU economy as a whole.

Would there not be legal obstacles to applying foreign tax law domestically?

There should not be. In the Commission's view it would not be necessary to change domestic tax codes in order to implement the pilot scheme. The Commission suggests using existing double taxation treaties or concluding an appropriate multilateral convention. Both have to be passed by national Parliaments and thus receive equivalent status of national laws. There are existing examples for this way of proceeding, for example as regards the tax treatment of construction works in many tax treaties. In most of the treaties which Member States have concluded with each other, construction works are not considered to constitute a taxable permanent establishment even when they fulfil all the conditions, provided their presence is limited in time.

Furthermore, Germany and the Netherlands have recently agreed on a protocol to their double-taxation treaty that allows companies to be active in border areas on the territory of the other state.
while having to comply with their domestic tax law only. So there is no reason why it should not be possible to use similar mechanisms for a limited Home State Taxation pilot scheme.

Would applying Home State Taxation only to small and medium-sized enterprises not discriminate against companies that are not allowed to benefit from the scheme?

The Commission does not believe so.

Most Member States already have special advantageous tax rules for SMEs and for these there seems no discrimination issue at national level. Moreover, the fundamental advantage provided by Home State Taxation is a reduction of compliance costs, not lowering of the tax liability. Such a non-monetary advantage is generally not considered as giving rise to discrimination.

What is the definition of an SME?

The Commission proposes using for the pilot scheme the general EU definition of SMEs as laid down in Commission recommendation 2003/361/EC, since this definition is common and familiar in all Member States. This definition distinguishes between:

- medium-sized enterprises [headcount < 250 and turnover ≤ € 50 million and / or balance sheet total ≤ € 43 million]
- small enterprises [headcount < 50 and turnover ≤ € 10 million and / or balance sheet total ≤ € 10 million]
- micro enterprises [headcount < 10 and turnover ≤ € 2 million and / or balance sheet total ≤ € 2 million]

In order to avoid any ambiguity, this definition should be binding for the purpose of the pilot scheme. Also, enterprises which are part of a larger grouping and could therefore benefit from a stronger economic backing than genuine SMEs, do not fall within the scope of this definition.

What is the definition of "Home State" for the purpose of this scheme?

The "Home State" of a participating SME-group is defined as the country of tax residence of the lead company. Following the generally accepted tie-breaker rule in bilateral tax treaties, this would, in case of doubt or of double-residence, be the country in which the place of effective management (or central management and control) of the lead company is located and where this company is subject to corporation tax before entering the pilot scheme. If there are problems with the application of this rule for the purpose of the pilot scheme, the tax administrations of the Member States in which the group is active have to reach a common agreement on the Home State; and otherwise the company cannot take part in the pilot scheme. The corporate tax base rules of the Home State would then apply to the participating lead company and its subsidiaries and/or permanent establishments in the participating Member States, ie to the Home State Group.

How long would the pilot scheme last?

By definition, the pilot scheme should be designed as an experimental trial and therefore be limited in time. For both the participating Member States (tax administrations) and the participating companies it will be important that the trial period is long enough so as to allow it to be analysed thoroughly and to justify the changeover cost. Based on the feedback received, the Commission suggests running the pilot scheme for a period of five years after which a final evaluation should take place. The time frame of five years is to be understood to mean that a start date for the scheme is
fixed and that the scheme automatically expires five years after that date (e.g. 1 January 2007 – 31 December 2011). Qualifying enterprises could, however, join the scheme at any time during the period and thus also participate for shorter periods (e.g. 1 January 2009 – 31 December 2011).

What specific cross-border tax problems do SMEs currently face?

Generally, the tax obstacles to cross-border economic activity are identical for small and medium-sized enterprises and larger companies. However, the impact of many obstacles on SMEs is stronger as they have, simply due to their smaller size, less economic and human resources and tax expertise available. There are two areas which are of additional, particular importance for SMEs.

First, SMEs have particular difficulties in meeting the compliance costs resulting from the need to deal with up to 25 different taxation systems. This finding is strongly supported by tax practitioners and business federations which represent SMEs’ interests. Available general studies suggest that compliance costs are regressive to size and put a disproportionately higher or even prohibitively high burden on small and medium-sized enterprises compared to bigger companies.

Second, among the other more specific tax obstacles to cross-border economic activity in the Internal Market, the cross-border offsetting of losses has been identified as the most important one from the perspective of SMEs. Losses often occur at the beginning of an activity in a foreign country, i.e., precisely when these activities are typically still run in a smaller enterprise. Bigger companies are usually in a position to make sure that all losses are eventually offset against profits, e.g. by using appropriate transfer pricing strategies. SMEs usually do not have this possibility. Moreover, given their usually limited capital cover, it is particularly important for small businesses to be able to set off losses. The Home State may provide greater access to finance at an essential stage in a company’s development life-cycle, lessening supply-side constraints imposed by risk adverse financial provision from banks and other financial institutions.

How would the scheme actually be established, if some Member States are interested?

The Commission suggests using the existing mechanism of double-taxation treaties to implement the pilot scheme. Interested Member States should thus enter into appropriate negotiations, prepare and conclude a bilateral or, preferably, multilateral agreement allowing interested companies to participate in the Home State Taxation pilot scheme. If they so wish, support and assistance for these efforts would be available from the Commission services, possibly via the Commission's FISCALIS programme of training for tax officials. The Member States concerned should then implement the agreement domestically, in accordance with their national laws and practices. A bilateral agreement could usefully take the form of a protocol supplementing the relevant double-taxation treaty, and multilateral agreements should be concluded in an intergovernmental convention. This way of proceeding would make sure that the pilot scheme could be introduced relatively quickly and in a flexible manner, while fully respecting the principle of legality of taxation. It is important to recall that Home State Taxation is based on the idea of voluntary mutual recognition of tax rules.

How could companies volunteer to participate?

On the basis of their agreement with other Member States, the tax administrations of participating Member States should, for instance via appropriate internal procedures (e.g. circular letters or publication of a call for 'expression of interest'), establish the possibility for companies to volunteer to participate in the 'pilot scheme'. Interested companies (both the lead company and subsidiaries) would have to notify their interest in taking part in the pilot scheme to their usual counterparts in the tax administrations of their respective residence States and these would be obliged to inform and consult without delay the tax administrations of the other Member States concerned. A decision on the application should be given by the two or more administrations concerned within a reasonable
period of time, e.g. two to three months after the notification of interest by the company. As with other administrative decisions a possible refusal should be accompanied by reasons and could only be justified if the applying company does not meet the requirements set out in the relevant agreement (for which there is no discretion for the authorities).

Would SMEs with head offices in third countries or indirect ownership via third countries be allowed to participate?

Given the narrow scope of the pilot scheme it is unlikely that SMEs with head offices in third countries would want to take part in the scheme in respect of their EU-wide activities in an EU group, as this would involve attributing the parent/head office function to one subsidiary for the sub-subsidiaries. Equally it appears to be improbable that SMEs with indirect ownership via third countries, i.e. a parent company in a Member State with a subsidiary in third country which holds a (sub-) subsidiary in another Member State, could qualify for the pilot scheme. While there is no need to systematically exclude companies of the first type systematically from access to the pilot scheme if they fulfil the basic requirements set out in the relevant agreement, and in particular comply with the definition of a small and medium-sized enterprise, there are good reasons to believe that the second situation would be too complicated to handle for the purposes of a pilot scheme. In the Commission’s services' opinion, indirect ownership via third countries or non-participating Member States should therefore disqualify a group of companies from participation taking part in the pilot scheme.

Would the scheme apply to corporation taxes only or to all taxes?

It seems sensible that the scheme should apply to corporation taxes only. Taxes other than corporation taxes should not be included in the scope of the scheme. This concerns in particular value added tax, excise duties, wealth tax, inheritance tax, land tax and land transfer tax. If they so wish, Member States could nevertheless continue to apply national or local profit-related surcharges on the corporate tax as established under the conditions of the pilot scheme (i.e. on that Member State’s share of the overall tax base). Non-profit related local or regional taxes could also continue to be levied under the rules of each of the Member States involved.

The pilot scheme should not indirectly influence the levying of taxes other than corporation tax. Insofar as the determination of the taxable income for corporation tax interacts with or impacts on the assessment of other taxes or social security contributions, and insofar as this link cannot be technically established on the basis of the Home State tax base rules, specific accounts should be kept on the basis of the Host State rules.

Would the scheme apply to SMEs in all sectors?

Several sectors of the economy are usually subject to specific corporate tax rules. For the purpose of an SME pilot scheme this might lead to additional complications that are hard to justify, either because very few, if any, SMEs are active in these sectors or because the sectors in question are often still national. Therefore, Member States might give some thought to the idea of stipulating that, for instance, 'Home State groups' with more than 10% of their turnover in the sectors of shipping, financial services, banking and insurance, oil and gas trade and exploitation, and agricultural activities (including forestry and fishery) should not be allowed to participate in the pilot scheme.

The definition of the sector should be based on the domestic taxation rules applied in the 'home state' concerned, but the tax administrations of the Member States concerned must in any event approve the sector allocation on a case-by-case basis. Alternatively, common EU definitions should be employed or, if need be, developed for the purpose of the scheme. The Commission services would be prepared to assist interested Member States with this task, where necessary.
What provisions would be established to prevent abuse?

The pilot scheme has to include rules for dealing with exceptional cases and anti-avoidance provisions. The Commission suggests a variety of possible arrangements to ensure this, including that only existing enterprises that have been tax resident in the 'Home State' for at least two years should be allowed to participate in the scheme and that a participating SME that moves its lead company's tax residence from one Home State to another during the pilot scheme would have to terminate its participation in the scheme. The Commission also proposes that the general anti-abuse rules of the State of residence apply for every group unit in relation to non-participating Member States and third countries, in order to forestall "rule shopping". A final point to note is that, generally speaking smaller companies are seldom audited at present so there should be no dramatic change for tax administrations as regards resources needed to combat tax fraud or evasion if some SMEs participate in the pilot scheme.

Would Member States conduct joint audits of participating SMEs?

The general rules for mutual assistance and administrative co-operation between EU Member States should apply and should be used. Moreover, the tax authorities of the interested Member States should, if this is considered necessary, form joint audit teams for auditing the lead company and group members. The audits should be allowed to be carried out by the joint team in all premises covered by the Home State group, but be strictly limited to those aspects governed by the pilot scheme. In the event of litigation it would be logical, in the Commission's view, to apply, in principle, the rules of the residence state of a "Home State group" member company. It seems difficult to envisage another solution that does not infringe the Member States' respective national laws.

Could an SME opt out of the pilot scheme before its expiry?

The decision by a company to take part in the pilot scheme should be binding for the entire five-year period or for a shorter period until the pre-determined end of the pilot scheme. If a company insists on ending the application of the scheme before the expiry of the five-year period, this could be made possible subject to a re-assessment of the tax years under the pilot scheme and retroactive application of the "traditional" rules.

What factors would be taken into account in apportioning the tax base between Member States?

For the purpose of this narrow pilot scheme it should be sufficient to use a simple but economically robust formula for apportioning the tax base between the participating Member States. This is because the tax revenue 'at stake' is limited by various factors: the restriction of the scheme to small or small and medium-sized companies; the limited number of small and medium-sized companies with establishments in other Member States; the optional character of the scheme; the strict monitoring that would apply; the generally low tax liabilities of SMEs etc. Moreover, a simple formula is easy to administer and operate.

The Commission recommends using the respective share in the total payroll (50%) and overall turnover (50%) of the participating business in each Member State concerned as apportionment formula. These figures are easy to identify in the company's accounting and tax declarations. Moreover, the combination of an input-related factor (payroll) with an output-related factor (sales) also reduces the possible arbitrariness.

At any rate, the following economic factors may also be used for devising the allocation formula: payroll; number of employees; sales (turnover); assets. Combining these factors would make the formula more economically representative but also more complex. Depending on the formula chosen
by Member States it would be necessary for them to agree on commonly accepted and practically operational definitions of the factors used.

How would the effectiveness of the scheme be monitored?

The Commission considers it advisable that, together with interested Member States, it should create a monitoring group to supervise the pilot scheme. The members of this group would consult one another, consider possible practical problems and assess the scheme's success. Moreover, it would make sense for those Member States implementing the pilot scheme to draw up, by 31 December 2009, a detailed report containing an overall assessment of the pilot scheme's effects. This would allow the Commission and the monitoring group to consider the possible prolongation or termination of the scheme and decide on the relevant procedures.

Have Member States, businesses and the European Institutions been consulted on this Home State Taxation idea?

Yes. The Commission services initiated a public consultation process on this idea in 2004. The consultation process included the organisation of a workshop, a public on-line consultation, bilateral meetings and the distribution of a questionnaire, all of them with the relevant stakeholders (i.e. business and accountancy/tax experts, national and European federations and organisations as well as some academics). Most interested parties considered corporate taxation as an important obstacle to cross-border expansion of SMEs and acknowledged the potential and positive contribution of the HST approach for helping and encouraging their economic activities in other Member States. The European Parliament and Economic and Social Committee also supported the idea of Home State Taxation for SMEs on a pilot basis and invited the Commission to take this concept forward.