

Summary Report on the outcome of the TAXUD Consultation of interested parties on *The experimental application of "Home State Taxation" to small and medium-sized enterprises in the EU* [February - June 2003]

Proceedings of the consultation

Following a very supportive 'workshop' with all relevant federations and other interested parties which took place on 17 December 2002 (a summary report is available separately) DG TAXUD on 19 February 2003 launched an on-line consultation at the TAXUD web-site. The consultation period officially ended on 30 April 2003 but responses were still informally accepted until the end of May. The consultation paper was first distributed to the participants of the workshop of 17 December 2002 and prior to the on-line publication further disseminated on request.

Key results

24 external contributions were received from a variety of national and European federations and organisations as well as some individuals (see annexed list below for details). Almost all contributions are supportive, many even very supportive. Most federations and academics are willing to co-operate on the pilot scheme but most make their contribution subject to a further assessment of the final design of the scheme. The efficiency and simplification gains, which the pilot scheme would bring about for small and medium-sized enterprises (SMEs), are generally acknowledged but many contributions also point out that it is too early for a final assessment of these. Moreover, many contributions highlight the risk of potential discrimination and/or competition problems of the pilot scheme and some even refer to possible constitutional problems in specific Member States. However, it is also frequently maintained that a pilot scheme, which is available to SMEs under a specific definition on an optional basis, could avoid such problems. Most contributions plead in favour of a real-life test approach for the pilot scheme although some consider theoretical simulations on the economic effects still a useful first step or 'backup'. A few contributions suggest that the pilot scheme should be run as a theoretical simulation only. The view that the existing EU definition of SMEs should be used for the purpose of the pilot scheme is overwhelmingly supported. A majority of contributions consider a relatively long or indefinite period as reasonable for defining the time limit of the scheme (e.g. at least 5 years) and refuse other types of limitations (e.g. the exclusion of specific sectors). Some form of EU framework for the pilot scheme is generally welcomed but most contributions remain relatively vague on this point. Some expressed firmer opinions on the details and precise legal form of this framework but these are divided. Almost all contributions maintain that the pilot scheme would be of merit even if not all Member States participated. This should be possible. A majority of respondents would like to include partnerships in the scheme but considers VAT as too different a tax for inclusion in the scope of the pilot project. On the other technicalities of the possible pilot scheme, a variety of - sometimes conflicting, sometimes complementing - views are presented. These concern questions like

- whether or not participating enterprises should file a pro-forma tax declaration in the country of activity;
- whether or not local profit taxes should be included in the scope of the scheme;
- which factors should be used for the formula needed for dividing the tax base between participating Member States;
- whether or not existing national tax incentives for SMEs are important for the pilot scheme; etc.

Outcome of the consultation - details per questions

General attitude of respondents to Home State Taxation (HST) and/or a potential HST pilot scheme

[Many respondents felt that before answering the various questions in detail, they should explain their general attitude to the issues raised in the paper and emphasise crucial points. These are summarised below]

Almost all contributions (22) are supportive, many even very supportive. It was emphasised that the scheme, which represented a step toward reduced bureaucracy and advancement of international competitiveness, would be beneficial especially because SMEs face relatively greater obstacles to cross-border economic activity than large companies. However, among the supportive contributions some also expressed some caveats. For instance it was maintained that the scheme should be adopted under a permanent basis to enable SMEs and Governments to be more decisive about adopting or accepting a HST system. In any event, the pilot should run for long enough such that the simplification benefits are not mitigated by administration changes. Some worries were also expressed with a view to disparities in national company tax law and fear of unfair tax competition. The need to address the issue of the allocation method and for a clear definition of the 'home state' were also underlined. Only a few contributions (3) were critical or even not favourable, for different reasons. In one case it is maintained that individual Member States may be better suited to accommodating the costs and inhibitions faced by SMEs setting up affiliations in other countries. Another contributor was strongly against what he felt would constitute a potential discriminatory tax burden for a foreign-owned subsidiary compared with a locally owned subsidiary. The particular situation in France (territoriality principle) was also referred to as a potential difficulty for a pilot scheme.

1) Would respondents from the business community (and notably the bodies representing SME interests) be prepared to co-operate on the design and testing of a 'pilot scheme'?

Various respondents felt that it was not appropriate for them to reply to the question or considered themselves not being in a position which would allow them to co-operate as members of the 'business community' (9). The remaining contributors, mainly representing federations at EU- or national level signalled their willingness to be actively involved in the design and testing of a 'pilot scheme'. One association however referred to the problem that their member companies are often not prepared to disclose internal data, which would make tests with concrete company data difficult. Another federation would prefer the pilot project to be launched in the form of an academic study to observe tax consequences.

2) Do respondents think that the arrangement under negotiation between Germany and the Netherlands could be usefully extended to other regions?

Various respondents felt that more detailed information would be needed for replying in a sensible manner to the query or did not consider this question (9). Among the other contributors, the opinions were divided in equal terms. Some considered this possible agreement as a useful source of information for the pilot scheme, in particular as regards the administrative arrangements. One respondent even attributed major importance to the possible agreement whereas others were more cautious and pleaded in favour of monitoring the arrangement for a number of years first. It was also said that the approach to be followed should imply foreseeing how this system could function if applied at EU scale and not to a

limited number of regions. Among those who were not of the opinion that the scheme could be usefully extended to other regions the main concern was that a bilateral solution would not be appropriate and that it covers too few companies in a too small geographical area. One federation maintained that the arrangement would not help many industries (e.g. the machine and plant construction industry and engineering) because it concentrates mainly on frontier districts. One respondent claimed that the arrangement seemed to contradict the apportionment objective of HST. And one considered the arrangements as too narrow in scope, suggesting that a merely bilateral approach would not cover all cross-border taxation issues.

3) *Would moving to 'Home State Taxation' for the taxation of small and medium-sized enterprises in the Internal Market deliver real simplification benefits and efficiency gains?*

Most respondents confirmed that the pilot scheme would result in the desired benefits for SMEs. Based on the expectation that the system would be straightforward to compute and depending on its concrete arrangements, in particular reduced compliance cost and simplification were identified as major advantages. Such reduced bureaucracy would already justify the introduction of the pilot scheme although it was also claimed that there should be a real reduction - and not just substitution- of compliance costs. Thus, some respondents expressed some caveats, for instance that the involvement of SMEs in any allocation of tax revenue should be minimised, that SMEs should be subject to tax audit only by their home jurisdictions and that companies should not be required to file accounts in the subsidiary State. Also, the advantages could be reduced with transitions to and from the HST scheme. In any event, a non-bureaucratic application of the scheme by tax administrations would be highly desirable. Moreover, especially for companies with focus on activities within the EU, there is also a potential for more far-reaching benefits (no transfer pricing, lower risk of double taxation, loss-offset, etc.). One contributor indicated that he needed still to be convinced of such benefits as in his opinion one of the main burdens of compliance is not the preparation of accounts and computations but in dealing with the tax authorities afterwards. Another respondent strongly emphasised the risk that the pilot scheme could result in new or additional compliance and real costs.

4) *What are respondents' views on the basic approach of the pilot scheme?*

While those respondents who replied to this question almost all took a favourable view on the basic approach of the pilot scheme, their reasoning and comments sometimes differ in detail. One respondent pleaded for introducing the scheme on a permanent basis to increase likelihood of SMEs and governments accepting and adopting the HST system. Various contributors emphasised that the pilot scheme should have a certain size and substance in order to gain significance. Several commentators also considered the fact that the taxing rights for individual Member States were retained and that the approach is based on the principle of mutual recognition, as major advantages. One respondent insisted that possible complications resulting from making the scheme permanent should be addressed from the outset, even if this meant limiting the scope of Member States or SMEs taking part in the pilot project. Some contributions expressed concerns about some outstanding practical difficulties and potentially significant problems relating to the allocation method. Moreover, it was maintained that there should be no change to long-standing concepts of tax law, such as that of the PE. Two respondents were particularly worried in this respect and referred to the merit of existing international rules (OECD).

- 5) *Is it considered necessary or suitable that in any event a SME, which fulfils its tax formalities under 'home state rules' with the tax authorities of its 'home country' only, still introduces a pro-forma tax declaration in all countries where it is active?*

Various respondents were against the filing of a pro-forma tax declaration in all countries of activities, which was considered to run against the desired simplification effect. One accepted the idea but only if necessary for the apportionment process. Several contributions argued in favour of a lighter procedure and suggested that the tax administrations could simply exchange copies of the normal tax declarations. Various respondents acknowledged the need for some form of pro-forma declaration but pleaded in favour of a standardised and brief form to be filled in the home language only.

- 6) *What are respondents' views on the possibility of a purely theoretical / hypothetical pilot scheme?*

A majority of contributions strongly plead in favour of a real-life test approach for the pilot scheme (14) as a purely theoretical exercise could miss problem areas and practical implementation issues. Many emphasised that only practical experience can draw conclusions close to reality. One respondent pointed out that a hypothetical scheme would cause high costs disproportionate to any benefits to participating SMEs. It could delay progress of the proposal and perhaps even be overtaken by emerging case law and bilateral agreements. However, some respondents considered theoretical simulations on the economic effects still a useful first step or 'backup'. For various reasons several commentators (4) preferred a purely theoretical exercise or academic study to a practical pilot scheme. One respondent pointed out that such a study would be easily possible for Member States on the basis of tax declarations in the two or more countries concerned.

- 7) *Is it considered feasible in practice to go beyond the practical testing of the approach in selected sample firms and implement a far-reaching and broad 'pilot scheme'?*

Many respondents (10) recommend a broad pilot scheme to ensure a representative sample of participating companies and favour a scheme which would allow all companies in a Member State with a business also in the co-operating neighbouring state, identified as an SME according to the special criteria set up, to participate. The fact that all SMEs should have the option to participate would also help to avoid potential discrimination problems. Moreover, a broad scheme would help companies to justify the operating/changeover cost of the pilot scheme. In any event, the pilot scheme should at least be sufficiently representative. However, several contributions (8) pointed out that at the beginning of the pilot scheme, a smaller sample consisting of a representative selection of enterprises or the inclusion of small enterprises only, could provide a useful starting point before the scheme is broadened. This would, among other things, have the advantage that the amount of tax revenue at stake for any Member State is not significant in budgetary terms. A few respondents (3) also referred to the risk that a too ambitious project could be insufficiently prepared and put the scheme into question.

- 8) *Would respondents consider that the SME-pilot scheme gives rise to serious discrimination and/or competition problems? If yes, could respondents indicate in which precise area/situation they see such problems?*

Many respondents (9) did not see any such problem arising, especially when the scheme is either optional or carried out as a strictly limited sample. Many other contributions (10) however acknowledge that there is at least a risk of discriminations or distortions, in

borderline cases; concerning companies in the same State applying different rules because they have different Home States; with a view to a foreign-owned subsidiary/SMEs compared with a locally-owned subsidiary/SME; or following a differentiation based on legal form of an SME. A few respondents (4) consider this issue as a very serious problem that could potentially block the whole pilot scheme.

9) *What are respondents' views on the potential infringement of the principle of neutrality in taxation (e.g. vis-à-vis the legal form of a business)?*

Many respondents (14) emphasise all legal forms should be included in the scope of the pilot scheme (individual enterprises, partnerships, agencies). Some (4) point out, however, that the principle of neutrality in taxation is already not always respected in Member States (e.g. UK, France) where there are considerable inequities in taxation between a company and an unincorporated business.

10) *Is it considered desirable or necessary to develop a proper definition of SMEs for the purposes of the pilot scheme?*

Many respondents support a uniform definition (11) and many of these favour the use of the EU definition of small and medium-sized enterprises. One contributor considers a definition based on the number of employees (up to 249) as sufficient. Several contributions (6) prefer having recourse to the existing national definitions of SMEs.

11) *What are respondents' views on the idea to apply the mutual recognition principle to the definition of SMEs (in order to take country-specific conditions into account)?*

Many respondents (11) prefer a common definition and refuse having recourse to the mutual recognition principle. One contribution could however support such an approach as an interim solution in order to get the pilot scheme started. Several respondents (4) speculate about the acceptability of this approach to Member States and most of them (3) expect that Member States would be sceptical. Some contributions (4) consider that national definitions could form a useful starting point but would need to be made coherent in some form for the purpose of the pilot scheme.

12) *Of the existing SME definitions identified, which would be the most useful for the purpose of the pilot scheme?*

Almost all respondents support the use of the EU-definition (13). Some suggest to limit the definition to the number of employees or payroll only (2) and one contributor argues that the broadest possible definition should be used.

13) *Which 'buffer rules' and transition arrangements would be desirable for dealing with borderline situations?*

Buffer rules are considered to be desirable for 'abnormal' income fluctuations, exceptional transactions and/or expanding enterprises (which at the beginning of the pilot scheme meet the definition but grow afterwards). One respondent suggests that buffer rules should be applied to businesses that would otherwise fall short of meeting the requirements for participating in the pilot scheme. Some contributors (3) suggest that there could be a rule that an SME must fail to meet the definition of an SME for two or three consecutive years. Another possibility mentioned is, for instance, allowing a certain time period to elapse between crossing one or more criteria and getting into or out-of the pilot project. One respondent maintains that such rules should prevent frequent transitions. Therefore, there

should be a lower limit for qualification for HST, and an upper limit for ceasing to qualify. Perhaps capital gains/losses from disposals of fixed assets should be omitted from HST, however balancing adjustments should be made for individual Member States' capital allowances. Several contributions (4) express basic doubts about the usefulness of such rules.

14) Is it considered necessary to define the scope of the pilot scheme by having recourse to additional criteria (other than size)?

With one exception, no contribution argues in favour of additional criteria for limiting the scope of the scheme.

15) What are respondents' views on the introduction of a time limit for businesses participating in the pilot scheme?

A majority of contributions (18) consider a relatively long or indefinite period as reasonable for defining the time limit of the scheme (e.g. at least 3 or preferably at least 5 years) and refuse other types of limitations (e.g. the exclusion of specific sectors).

16) Are there any sectors, which could be usefully identified for defining the scope of the pilot scheme?

No contribution but one argues in favour of limiting the scope of the scheme to specific business sectors. One respondent suggests excluding the property sector (not the construction industry)

17) What are respondents' views on the treatment of activities in third countries or income therefrom? Is it considered suitable to provide for a territorial limitation of the pilot scheme?

Most respondents who have replied to this question are in favour of a territorial limitation that would exclude third-country activities and income from the scope of the pilot scheme.

18) Is it considered necessary and feasible to include partnerships in the scope of the pilot scheme?

Some contributors (4) wish to exclude partnerships from the scope of the pilot scheme. It is argued that including unincorporated businesses in the scheme would be likely to cause unnecessary complexities, perhaps jeopardising the project. Most respondents however are in favour of including partnerships in the scope of the project (15). Some refer to the special problems relating to hybrid companies.

19) If partnerships would be included in the pilot scheme's scope, should this be done under a "tax treaty approach" or under a "consolidation approach"?

Many respondents felt that they were not in a position to answer this question and pleaded in favour of a more in-depth analysis of the problems. Several contributions (7) nevertheless favour the consolidation approach while a few others (2) argue that there is a legal basis only for a tax treaty approach.

20) *Are there significant tax incentives, which are relevant for SMEs, that would impact on the feasibility of the proposed pilot scheme? If yes, which and in which countries?*

Most respondents do not consider this issue a major problem or indicate that they do not have knowledge of such tax incentives. Some (3) argue that an EU-wide comparative survey would be needed in order to address the issue properly. Specific examples for SME tax incentives are given for Germany (minor), France and the UK.

21) *Is it considered necessary to provide for special rules on the treatment of tax incentives (e.g. by transforming these, within the scope of the pilot scheme, into tax credits)?*

If need be, the idea of transforming tax incentives into tax credits was considered by several respondents (8) as a possible way forward. Most contributors felt, however, not in a position to answer this question in a sensible way. One contribution argues that mutual acknowledgement of the tax base regulations would be sufficient. Another contribution suggests a preliminary comparison of tax incentives and national accounting rules of all participating Member States. Another one emphasised that removing special rules would make the pilot uninteresting for enterprises.

22) *What are respondents' views on the proposed exclusion of VAT from the range of taxes covered by the pilot scheme?*

The majority of respondents (16) are against the inclusion of VAT into the scope of the pilot scheme. Its inclusion is said to unnecessarily complicate the project while the underlying issues are not fully explored. Corporate taxes and VAT are based on different rules and approaches and in some countries administered by different services. There would even be the risk to possibly 'derail' the direct tax initiative. Some commentators nevertheless support the inclusion of VAT (3), for instance with a compensation mechanism across MS's (following the example of the e-VAT Directive) or as a parallel scheme.

23) *What are respondents' views on the proposed inclusion of profit-based local profit taxes in the range of taxes covered by the pilot scheme?*

Many respondents (12) agree to the inclusion of local profit taxes, at least inasmuch as these relate to corporate taxes, in order to obtain the full benefits of the simplification which HST will bring. Otherwise there would be no uniform tax treatment of the group income. However, there are also several contributions (5) against the inclusion of taxes, which are not common to all Member States. It is also maintained that local profit taxes do not of themselves cause problems but these will arise where local taxes are not computed on a profits basis but some other method, e.g. property valuations. There might also be difficulties as those taxes are generally applied by authorities other than the central tax authorities.

24) *What are respondents' views on the proposed means for including local profit taxes into the pilot scheme? Are there country-specific aspects to be taken into account and, if so, which?*

Most respondents did not answer this question. Some contributions (5) referred to specific problems relating to trade tax (*Gewerbesteuer*) in Germany and local taxes in France and the UK.

25) *If a broad scope of the pilot scheme is being decided, is it considered necessary to provide for a revenue or base allocation mechanism? If so, which would be preferable?*

Most respondents agree with the need to establish an allocation or apportionment procedure (13). Many argue in favour of base allocation (5) and refuse the recourse to a direct compensation mechanism for tax revenues, which is however supported by one contribution. Some contributors consider that they cannot choose between these methods (4). Some (3) also argue that this question should be left to tax administrations to decide. One commentator suggests to use a simplified value added formula.

26) *Would there be particular difficulties in collecting the data necessary for applying an apportionment formula based on 'sales' or one based on 'payroll'?*

Many respondents (9) do not consider that the data collection would give rise to significant problems. There are few indications about which factors would be favoured: sales (2), value-added (1), payroll (3), assets (1).

27) *Would there be particular difficulties in collecting the data necessary for applying an apportionment formula based on 'value added'?*

Most respondents who answered this question (13) consider that a formula based on 'value added' would be too complex. If ever, some (2) argue that only a simplified value added formula could be used.

28) *What are respondents' views on a direct revenue compensation mechanism between Member States?*

Most respondents (11) are against the use of a direct revenue compensation mechanism between Member States. It is doubtful whether it is possible to operate such a mechanism properly in practice and co-operation between tax authorities is presumably not sufficiently developed. One contributor however, maintains that this approach should represent the less burdensome solution for SMEs.

29) *What are respondents' views on the proposed intensification of mutual assistance and information exchange between tax administrations as well as the increase of joint audits?*

The majority of respondents (14) consider such co-operation either highly desirable or even absolutely necessary. However, some commentators (4) also fear negative consequences and additional burdens and costs for the participating SMEs. One contribution rejects the idea of joint audits.

30) *Is it considered valuable to launch the pilot scheme even if it was not introduced in all Member States?*

With two exceptions, most respondents (15) who answered this question (17) considered that it was not necessary to run the pilot scheme in all Member States. Some even argued that it might be best to start with a relatively local pilot scheme so that practical solutions may be tested and arrived at before extending the scheme to all Member States. One contributor argued that it might be appropriate to launch the scheme in countries with common land borders, where cross-border trading may be most common. In any event, each Member State should be given the opportunity to participate.

31) Is it considered necessary to provide a coherent EU wide framework for the pilot scheme which would set out the rules for all Member States, regardless of whether or not they implement the scheme in practice?

The majority of respondents (16) are of the opinion that some form of EU framework is desirable or necessary for the pilot scheme. This would avoid numerous differently arranged agreements between Member States, so removing simplification benefits. Only one contribution argues that this is not necessary as there might be merit in restricting the pilot scheme to a limited number of States where there are real problems with cross-border trading.

32) If an EU legal framework for the pilot scheme is being favoured, is it considered necessary to provide a legally binding instrument (which would fall under the control of the European Court of Justice)?

Most respondents (11) favour a legally binding instrument or even consider it necessary for the pilot scheme. A high degree of legal binding is said to strengthen confidence in the pilot project, from participating and non-participating States, and to ensure legal certainty as well as a standardised implementation in all Member States. Several contributions (5) consider, however, that more formal procedures are not necessary - maybe for a final system but not for the pilot scheme. The purpose of the pilot scheme would just be gaining initial experience.

33) Are there any other issues which respondents wish to raise or comment on? If so, which?

Some organisations wonder which form of concrete support they could lend in order to support the project and speed up its implementation. Some respondents raise related technical issues/questions such as the level of ownership interest in SMEs participating in the scheme or the effect on domestic traders in the 'other' State. One contribution refers to the potential impact of the possible pilot scheme on personal income tax, social security rules, payroll taxes, differing legal systems etc. Another contribution highlights the difficulty that may arise in coordinating relevant tax laws in the different Member States.

Contributors to the consultation

<i>n°</i>	<i>Contribution by</i>	<i>Received on</i>	<i>Language</i>
1	ACCA - Association of Chartered Certified Accountants	17.9.02	EN
2	Prof. Sven-Olof Lodin	19.9.02	EN
3	ZEW - Zentrum für Europäische Wirtschaftsforschung / Centre for European Economic Research	13.12.02	EN
4	Prof. S. Plasschaert	15.12.02	EN
5	ZDH - Zentralverband des deutschen Handwerks (German craft association)	10.1.03	DE

6	VDMA - Verband Deutscher Maschinen- und Anlagenbau (German mechanical industry federation)	5.3.03	DE
7	UEAPME - European Federation of craft, small, and medium-sized enterprises	14.3.03	EN
8	City of Westminster and Holburn Law Society	17.3.03	EN
9	PWC - PriceWaterhouseCoopers (London Office, Mr Peter Cussons)	28.3.03	EN
10	BStbK - Bundessteuerberaterkammer (Chambers of German Tax Advisors)	31.3.03	DE
11	MAZARS Tax Advisors	31.3.03	EN
12	DIHK - Deutscher Industrie- und Handelskammertag (German Chambers of Commerce Organisation)	31.3.03	DE
13	The Law Society of England and Wales	3.4.03	EN
14	APCM - Assemblée permanente des chambres de métiers	14.4.03	FR
15	FEB - Federation of Enterprises in Belgium	30.4.03	EN
16	Eurochambres	30.4.03	EN
17	Adam Craig	30.4.03	EN
18	Pierre Fauquet	1.5.03	FR
19	Institute of Chartered Accountants in England and Wales - Tax Faculty	2.5.03	EN
20	EuroCommerce	2.5.03	EN
21	Conseil Supérieur de l'Ordre des Experts-Comptables	5.5.03	FR
22	The Chartered Institute of Taxation (UK)	13.5.03	EN
23	FEE - European Federation of Accountants	11.6.03	EN

<p>A report by the 'Committee for International Taxation' of the <i>Consiglio nazionale dei dottori commercialisti</i> on all comprehensive reform (received on 19 May 2003) options supports HST and in particular the idea of applying it initially to SMEs. - Moreover, they consider that the tax base rules in Member States are sufficiently similar so as to allow HST to work without major distortions and discuss various technical aspects of HST. Finally, they suggest the adoption of HST as a "temporary solution" to improve a more friendly taxation of European transnational companies in the short term.</p> <p>O.d.C. also think this system of taxation could be adopted simply for a significant part of Member States in the framework of enhanced co-operation.</p>	<p>IT</p>
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