# BEFIT, TRANSFER PRICING, SMEs

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## BACKGROUND

1. **Business in Europe: Framework for Income Taxation (BEFIT)**
2. **Common Approach to Transfer Pricing (TP)**
3. **Head Office Tax (HOT) rules for certain SMEs**

## 1. Business in Europe: Framework for Income Taxation (BEFIT)

BEFIT is a new legislative framework for corporate taxation in the EU. It introduces **common rules for computing the taxable results** of group members which operate in the internal market. The overall aim is to simplify tax rules and to ensure a level playing field for businesses in the EU. The framework builds on international developments in the field of corporate taxation, such as the OECD/G20 Inclusive Framework Two-Pillar Approach, and reflects the realities of the modern economy.

BEFIT rules will be **mandatory for large groups** operating in the EU with annual combined revenues of at least EUR 750 million provided that the group prepares consolidated financial statements. This aligns the mandatory scope of BEFIT with the Pillar Two Directive adopted last year. Certain materiality thresholds will keep groups with a limited presence in the EU out of the mandatory scope of BEFIT in order to balance the burdens and benefits of the new system. However, the BEFIT rules will be optional for all groups (not covered by the mandatory scope) as long as they prepare consolidated financial statements.

To arrive at the taxable base for these groups, the first step is to **compute the preliminary tax result of each group member based on their financial accounts** which must follow accounting standards accepted under EU law, i.e., a national Generally Accepted Accounting Principles (GAAP) of a Member State or the International Financial Reporting Standards (IFRS). A limited number of tax adjustments, e.g., with regard to depreciation, are applied to the financial accounts to convert them into a tax base. The preliminary tax results of all group members will be **aggregated into one single tax BEFIT base.** This will entail cross-border loss relief, as losses will automatically be set off against profits across borders, as well as increased tax certainty in transfer pricing compliance for transactions within the BEFIT group.

As a second step, the aggregated tax base will be **allocated to the group members using a transitional allocation rule.** Accordingly, each group member will have a percentage of the aggregated tax base calculated as the average of the taxable results in the previous three fiscal years. Member States may allow for additional national adjustments to the share allocated to group members in their jurisdiction, which will leave room to address important national policy choices. The transitional rule may pave the way for a permanent allocation method that can be based on a formulary apportionment using substantive factors. The transition solution will allow the Commission services to take into account more recent data on the impact of the implementation of Pillars One and Two of the OECD/G20 Inclusive Framework on national tax bases and also benefit from better quality Country-by-Country Reporting (CbCR) data, which will provide a better picture of the current tax environment.

In pricing transactions between BEFIT group members and associated enterprises outside the BEFIT group, the system will **facilitate transfer pricing compliance** through a new risk assessment tool referred to as the **‘traffic light system’.** The substantive transfer pricing rules are not affected by the BEFIT rules.

The **administration** of the BEFIT rules will be carried out **through a hybrid one-stop-shop.** This entails that the process will be partly centralised as one group member will file the BEFIT information return with one tax administration in the EU. For each BEFIT group, a ‘BEFIT Team’ will be formed by representatives from the relevant national tax administrations, to ensure coordination and closer cooperation with a view to reaching tax certainty. Individual tax returns of group members, along with audits and appeals, remain local in the Member States. The hybrid system will prioritise simplicity and provide for an efficient use of resources.

## 2. Common Approach to Transfer Pricing (TP)

Transfer Pricing (TP) is a central tenet of international corporate taxation. It allows to **allocate income earned by a multinational enterprise among those countries in which it does business**. TP rules are based on the arm's length principle (ALP). In simple terms, the ALP prescribes that individual group members of a multinational enterprise (MNE) must transact with each other as if they were independent third parties.

The TP proposal lays down rules to ensure a common approach to TP with the aim of **increasing tax certainty and reducing occurrences of double taxation as well as double non taxation**. The proposal (i) incorporates the arm's length principle and key TP rules into Union law, (ii) clarifies the role and status of the OECD TP Guidelines and (iii) creates the possibility to establish common binding rules on specific subjects.

Firstly, the proposal **enshrines the arm's length principle into the EU law** by establishing that associated enterprises must transact with each other as if they were independent third parties. The proposal also **provides for key TP rules**, in particular:

- To ensure that the arm's length principle is applied in a uniform way across the Union, the proposal provides a **common definition of associated enterprises** which is the pre-condition to apply transfer pricing rules.
- The proposal provides for the various **TP methods** that should be used to establish the arm's length prices and clarifies how to select the most appropriate method for a particular transaction.
- The proposal explains how a **comparability analysis** (comparing transactions between associated enterprises and between independent enterprises) should be performed to assess whether the transaction is at arm's length.
- To minimise disputes, the proposal clarifies how the range of acceptable transfer pricing outcomes should be defined.
- The proposal requires Member States to put in place adequate mechanisms to enable them, to adjust the tax base booked in their country ("**corresponding adjustment"**) after a primary adjustment has been made in another Member State or third country jurisdiction. This aims at mitigating double taxation. In addition, the proposal provides the conditions under which Member States should recognise a compensating adjustment.
- The proposal finally stresses the need for taxpayer to gather all the necessary **TP documentation**. The Commission shall make proposals to further specify which documentation is needed. This will be done my means of delegated act.

Secondly, it is clarified that the rules laid down in the proposal should be applied in in a manner **consistent with the OECD TP Guidelines**. As the OECD TP Guidelines will be amended over time, these amended guidelines should become the new binding reference framework, if these changes have been agreed by all Member States.

Finally, in order to create more certainty for taxpayers and mitigate the risk of double taxation, the proposal provides for the **possibility to establish further common binding rules on how to apply TP rules** by way of implementing acts. Such rules would consist mainly in safe-harbours and would remain fully consistent with the OECD Guidelines.

## 3. Head Office Tax (HOT) rules for SMEs with permanent establishment(s) operating in (an)other Member State(s)

If SMEs wish to operate cross-border, they become taxable in more than one Member State as soon as their activity abroad creates a permanent establishment (PE), **and they need to comply with 27 different tax systems**. Compliance with those obligations comes with fixed costs, which are a barrier to developing business cross-border. This is **especially the case at the inception stage of expansion** when the activities carried out abroad would mainly be ancillary to the primary business operations in the state of origin.

**SMEs spend approximately 2.5% of their turnover on compliance** with their tax obligations (e.g. CIT, VAT, and income taxes) while large enterprises spend 0.7%[1].

The SME simplification initiative will eliminate the complexities and related costs of SMEs having to deal with multiple tax systems and tax administrations. It proposes an **optional set of rules for computing the tax result of PEs** (head office tax system), which will be coupled with a **centralized one-stop-shop for filing and collecting tax.** The determination of the **tax rate** applied to a PE will remain within the full competence of the Member State where the PE is situated**.**

**The proposal has a limited scope.** It will apply only to SMEs at their initial stage of expansion in the internal market through PEs. PEs are not separate legal entities**;** they are part of the legal personality of the SME itself. It should also be noted that SME groups (i.e. SMEs with subsidiaries) can opt for creating a group within the BEFIT framework if they prepare consolidated financial statements.

**The eligibility and termination provisions** are designed to discourage tax abuse and potential tax planning practices**,** such as the transfer of the head office to a Member State with attractive features in its tax system. The option for the SME simplification rules lasts **5 years** and has to be renewed, in order to remain in the system. An SME is however disqualified from the possibility of such renewal, e.g. when a standalone SME sets up a subsidiary or ceases to qualify as an SME altogether. There are also reasons which terminate the application of the simplification rules in respect of an SME in the course of the 5-year option, e.g. the head office changes tax residence or the joint turnover of the PEs exceeds an amount three times that of the head office.

A **one-stop-shop** will allow in-scope SMEs to interact with only one tax administration, i.e. that of the Member State of their head office (for tax filing and collection). SMEs will thus file **one single tax return** with the **tax administration of their head office** for all their PEs and the head office. This **tax administration will**

[1] European Commission. (2022). Tax compliance costs for SMEs. An update and a complement : final report https://op.europa.eu/en/publication-detail/-/publication/70a486a9-b61d-11ec-b6f4-01aa75ed71a1

**also collect the tax due to the MS of the PE** and then transfer the amounts to the entitled Member State(s).

The amendment to the Directive on Administrative Cooperation will accommodate the modalities for the exchange of information between the respective tax authorities.