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**HOME STATE TAXATION FOR SMALL AND MEDIUM-SIZED
ENTERPRISES**

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INTRODUCTION

More than ten years after its creation, the Internal Market is still far from being exploited to its full extent by Europe's small and medium sized enterprises (SMEs). This means that a big potential for more growth and employment is foregone.

Taxation and in particular tax-driven compliance costs are one of the main reasons for this collective failure. Economic research shows that the costs for complying with the tax laws of another Member State are drastically and disproportionately higher for SMEs than for larger companies. Thus, it is no surprise that SMEs hesitate to create establishments abroad, even when this would be otherwise economically sensible.

Based on scientific work and proposals the Commission has therefore elaborated the idea of an experimental Home State Taxation (HST) pilot scheme for SMEs. This approach is based on the idea of voluntary mutual recognition of tax rules and does not imply any harmonisation of national rules at EU level. It tackles precisely those tax problems that hamper SMEs most in the Internal Market by providing, in simple terms, that the profits of a group of companies active in more than one Member State should be computed according to the rules of one company tax system only, the system of the Home State of the parent company or head office of the group. Each participating Member State would continue to tax at its own corporate tax rate its share of the profits of the group's business activities in that State. In all likelihood only Member States with a broadly similar tax base would enter into an appropriate agreement. An illustration of the functioning of the Home State Taxation and a list of key points defining the scope of the pilot scheme under consideration by the Commission are annexed.

The Commission services are currently also working on the longer term objective of a common consolidated tax base. This is however different in almost all respects. The two projects are complementing and not overlapping or interfering with each other. HST provides pragmatic short/medium term assistance for smaller companies whereas the Common Tax Base constitutes a systematic taxation complement to the Internal Market.

DISCUSSION SO FAR

The HST pilot scheme is very strongly supported by the business community concerned. The measure also forms part of the Entrepreneurship Action Plan which has recently been welcome by Member States at political level. In a working group meeting in March 2004 the 15 "old" Member States have, however, at least at technical level, voiced a number of concerns. The Commission considers that these should not be overemphasized and that the underlying issues can effectively be dealt with. A pragmatic and modest initiative aiming at the mobilization of the growth potential of SMEs should not be scuppered by administrative inertia!

For instance, it was maintained that the technical complexities of the pilot scheme under consideration were such that its costs were not justified by potential benefits. This view overlooks that what is proposed is a pilot scheme limited both in time and scope. The objective is to test the expected benefits of Home State Taxation in addressing the tax problems of SMEs in the Internal Market; not to permanently overhaul existing taxation practices. Therefore, the effective practical repercussions on national tax administrations concerned will be limited; in particular as the scheme's implementation will be backed up by Commission research and assistance. Indications both from the SME Community and economic research show that the problems to be addressed are real and serious and that Home State Taxation can be expected to tackle these effectively.

Moreover, it was maintained that there were cumbersome and time-consuming procedural requirements for implementing such an initiative in the internal laws of the participating Member States as the tax laws of the partner states had to be integrated into domestic tax law. The Commission suggests, however, 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 which is why the transposition of foreign tax rules in national laws does not seem to be necessary, especially for a pilot scheme. There are also examples for this way of proceeding which are comparable to the HST idea, for example in as regards the tax treatment of construction works in many tax treaties.

Finally, the Commission considers that there are no particular discrimination issues arising from the fact that the pilot scheme under consideration would be limited to smaller companies only. It should also be noted that at EU-level small and medium-sized enterprises are subject to specific State Aid rules and that in many Member States there are also special advantageous tax rules for SMEs. Both aspects would make potential competition/ discrimination problems that are inherently linked to any limited pilot project less acute.

CONCLUSIONS AND NEXT STEPS

The Commission considers that the Home State Taxation approach in all likelihood provides a realistic and effective means to address the specific tax compliance problems of SMEs in the Internal Market. Clearly Home State Taxation does not provide a systematic long term "tax solution" for the Internal Market (like the Common Consolidated Tax Base does) but its potential benefits for SMEs and consequently the broader EU economy should not be left unexploited. The approach should therefore be tested in practice. Thus, the Commission is in principle committed to present a recommendation setting out the modalities of an appropriate Home State Taxation pilot scheme for SMEs towards the end of 2004. It would then be for Member States to follow this recommendation and agree on appropriate pilot schemes.

At this stage the Commission does not seek detailed agreement or firm commitments from interested Member States. But, it needs an indication of how many Member States are broadly supportive in principle of the forthcoming initiative and whether Member States were prepared to consider the relevant technical and legal issues with the necessary constructive and open spirit.

Illustration of the basic functioning of the Home State Taxation scheme

Description of facts

A group of companies has the following structure:

- Parent company PA, located in Member State A
- Subsidiary DB, located in Member State B
- Subsidiary DC, located in Member State C
- Sub-Subsidiary DDC, located in Member State C

<i>Member State A</i>				<i>Member State C</i>	
	PA	→	→	DC	
	↓			↓	
	↓			↓	
	DB			DDC	
<i>Member State B</i>					

Definition of terms:

- Companies PA, DB, DC and DDC can form a "Home State Group"
- Member State A is the "Home State"
- Member State B is "Host State" for DB
- Member State C is "Host State" for DC and DDC
- Member States A, B and C will formalise their cooperation in the pilot scheme by appropriate legal instruments, e.g. via a multilateral "Home State Convention" or "Home State agreement"

Functioning of the scheme:

- PA establishes the taxable income of PA, DB, DC and DDC according to the tax legislation of Member State A
- The tax base so established is apportioned among Member States A, B and C following a simple key, e.g. the proportions of payroll and/or turnover in each jurisdiction
- PA files a group/comprehensive tax return in Member State A and pays tax
- DB files self-assess and pay their individual tax liability in Member State B
- DC and DDC file self-assess and pay their individual tax liability in Member State C

Key points

Basic approach: Under the pilot scheme, SMEs active in more than one Member State can compute their taxable income (tax base) according to the rules of the system of the Home State of the parent company or head office only.

Tax rates: Each participating Member State continues to tax at its own corporate tax rate its share of the profits of the group's business activities in that State.

Which SMEs: Either small and medium-sized enterprises or, if need be from a Member States' perspective, only small enterprises in the official EU definition of SMEs can participate in the pilot scheme.

Who is part of the group: The group of businesses included for the SME in the scheme is defined on the basis of the Home State rules.

Partnerships are not included in the scope of the scheme unless the tax administrations concerned agree on a specific individual request.

Timeframe: The pilot scheme runs for 5 years (e.g. 1 January 2007 – 31 December 2011).

Sectors of economy: Specific sectors which are subject to separate tax rules are not included in the pilot scheme (e.g. shipping, agricultural activities, etc.)

Which taxes: Taxes other than corporation taxes are in principle not included in the scope of the scheme. However, Member States could continue to apply national (profit-related) surcharges on the corporate tax or corporate tax base as established under the conditions in the pilot scheme

Which is the Home State: The "Home State" of a participating SME-group is defined as the country of tax residence of the parent company (or headquarter), if need be with the help of the usually applicable tiebreaker rules.

Administrative rules: The pilot scheme includes specific anti-avoidance rules and provisions for special cases (e.g. change of ownership; business expansion, business fluctuations etc.).

Tax assessment and payment: Participating companies will self-assess, report and pay the local tax but the calculation of the combined profits of the group will only need to be filed by the parent company in the Home State. The other tax administrations concerned receive copies.

Allocation formula for tax base: The tax base as established on the basis of the Home State rules is apportioned on the basis of a simple formula (e.g. payroll) among the Member States concerned.

Third country income of group members falls outside the scope of the scheme and is added to the income of the group member after apportionment.

Tax audits would be carried out by the home state authorities, if need be jointly with the partner administration. The general rules for mutual assistance in the EU would apply.

Economic Impact Assessment: The economic impact of the pilot scheme has to be assessed beforehand and interested parties are requested to provide the relevant data and information.

Legal framework: The Commission would issue a recommendation on the basis of which Member States would prepare and conclude a bilateral or multilateral agreement. The Member States concerned would then implement the agreement domestically following their national laws and customs.

Monitoring: Commission and Member States create a monitoring group for supervising the pilot scheme, considering possible practical problems and assessing its success.