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Outline of a possible experimental application of Home State Taxation to small and medium-sized enterprises

The basic concept and the fundamental objective of the Home State Taxation pilot scheme are very simple: to tackle the tax obstacles encountered by small and medium-sized enterprises when they operate in other EU Member States in addition to their own by granting them the possibility to apply the well-known corporate tax rules of their home state only. Thus a SME would be allowed to calculate the taxable profits for the parent company together with all its qualifying subsidiaries and permanent establishments in other participating Member States according to the tax base rules of its home state. The tax base so established would then be allocated to the Member States concerned in accordance with their respective share in the total payroll. Each Member State would subsequently apply its national tax rate.

The following document explains the technical details of this concept in detail so as to allow interested companies to form their opinion on the practical utility of the proposed pilot scheme and, if they consider this useful, provide the Commission services with additional input. It should be noted that the technicalities of the scheme as explained hereafter seek to cover every possible situation and potentially complex issue in relation to the pilot scheme the application of which should in practice nevertheless be easy and straightforward for the vast majority of participating SMEs.

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.

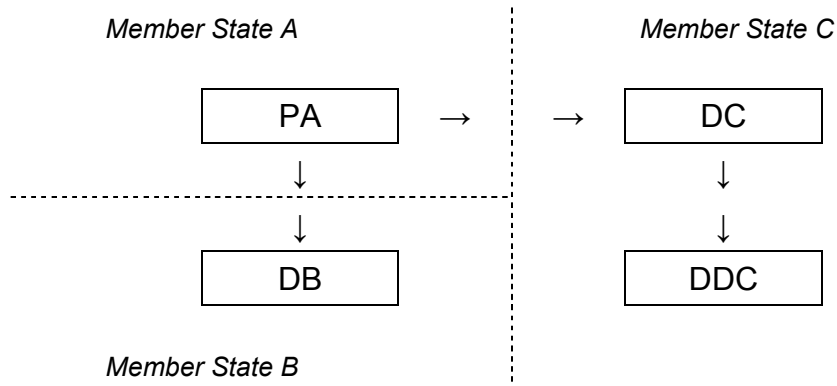
BACKGROUND

The purpose of this document is to provide an outline of the technicalities of a possible "Home State Taxation" pilot scheme which would allow small and medium-sized enterprises (SMEs) to apply this approach on an experimental basis to their economic activities in the EU. An appropriate Commission recommendation is in principle planned for 2004. It is hoped that the information given in the present document will enable interested parties to form an opinion on the utility of the proposed scheme for their own purposes. The fundamental approach of the pilot scheme is based on the idea of voluntary mutual recognition of tax rules concerning SMEs. It provides, 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. No harmonisation of rules is sought. The pilot's objective is to address those tax problems that hamper SMEs most when expanding cross-border and often even prevent them from benefiting fully from the Internal Market's potential. The following diagram illustrates the basic functioning of the scheme under consideration and defines the related technical terms as hereafter used in this document.

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



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

This project has been gradually built up over the last three years, starting with the publications on Home State Taxation by its authors Malcolm Gammie and Sven-Olof Lodin ("Home State Taxation"; IBFD Publications 2001), and continuing with the Commission work on a new company taxation strategy as well as the reaction thereto. In 2003 the Commission services carried out a public consultation on this idea and subsequent (both formal and informal) discussions with experts from the business community and the academic world have led to further refinement of the project. Detailed working papers, summaries, official documents and reports are available on all of these preparatory works (for instance at the Commission web-site¹) and the relevant arguments are not repeated here. On this basis, the Commission, in its Communication "*An Internal Market without company tax obstacles – achievements, ongoing initiatives and remaining challenges*" [COM(2003)726], presented specific ideas for taking the pilot scheme further and proposed a number of concrete key points on how such a pilot scheme could be usefully designed.

In a working group meeting with Member States on 11 March 2004, delegations expressed however strong or even very strong reservations against the project. Without a clear plea for its introduction by the businesses concerned, the project would therefore in all likelihood not be proposed or even implemented in practice.

DEFINITION OF PARTICIPATING COMPANIES

The pilot scheme's scope should, in principle, be defined by reference to the existing EU definition of SMEs (Commission Recommendation 2003/361/EC). This definition distinguishes

- 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]

Moreover, 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. Given Member States' reluctance towards a too "generous" definition, thought could be given to the inclusion of small companies only. Restricting the pilot to micro enterprises is no viable option.

The tax rules of the Home State in principle apply to the participating company (parent company/headquarter company) and its subsidiaries and/or permanent establishments in the participating Member States. Whether or not these activities of the participating company are effectively included in the 'Home State group' (i.e. the group of companies participating in the scheme) for the purpose of the pilot scheme depends on the domestic group taxation rules of the Home State² and conditions defined therein (minimum participation; financial

¹ http://europa.eu.int/comm/taxation_customs/taxation/consultations/home_state_sme.htm

² E.g. *Organschaft*, group contributions etc. That is also to say that world-wide consolidation schemes like in Denmark, France or Italy would not be applicable in the pilot scheme context. Moreover, those Member States which do not operate a domestic group taxation scheme at all will probably find it less attractive to take part in the pilot scheme.

control etc.). Under no circumstances would a company (parent or subsidiary) be allowed to be part of two different "Home State groups" (which would be impossible if a clear majority ownership criterion is applied). Thought could alternatively be given to fix generally applicable rules, for instance introducing a 100% or 75% or 51% minimum ownership requirement.

PARTNERSHIPS

Given the inherent technical difficulties to include partnerships and other transparent or hybrid entities in the scheme's scope it seems that only incorporated companies should a priori be given the opportunity to participate in the pilot scheme. Including internationally active partnerships in the scope of the scheme would potentially lead to very complex problems of double-taxation and the application of double-taxation treaties. Such a scheme would in all likelihood be effectively extended into personal income taxation. It is therefore suggested that partnerships can only be accepted for participation in the scheme in exceptional cases, which have to be analysed by the tax administrations of the Member States involved on a case by case basis. In any event only commercially active partnerships with business income could apply for participating in the scheme.

TIMEFRAME OF THE PILOT SCHEME

For both the participating Member States / tax administrations and the participating companies it will be important that the test run period is sufficiently long so as to allow it to be analysed thoroughly and to justify the changeover cost. Based on the representations received it is suggested to run the pilot scheme for a period of 5 years after which a final evaluation should take place. The time frame of five years is to be understood so 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). SMEs could however join the scheme throughout the period and thus also participate for shorter periods (e.g. 1 January 2009 – 31 December 2011).

SECTORS COVERED BY THE PILOT SCHEME

Other types of limitations (e.g. to specific regions) do not appear to be desirable or necessary. Moreover, there is no need to exclude large economic sectors. However, there are some sectors which are usually already subject to specific tax rules. It is thus suggested to exclude groups of companies with substantial activities (more than 10% of their turnover) in such sectors from the possibility to take part in the pilot scheme. This could in particular concern shipping, financial services, banking and insurance, oil and gas trade and exploitation, and agricultural activities (including forestry and fishery).

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 agree to the sector allocation on a case by case basis.

TAXES COVERED

It is suggested that taxes other than corporation taxes not be included in the scope of the scheme (VAT; excise duties; wealth tax, inheritance tax, land tax, land transfer tax etc.). As regards local taxes, Member States would be allowed to continue applying national profit-related surcharges on the corporate tax as established under the conditions of the pilot scheme (i.e. on that Member States' share of the overall tax base). Other, non-profit related

local or regional taxes could also be continued to be levied under the rules of the residence / Host state.

DEFINITION OF 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). Following the usually applicable tiebreaker rule this is the country in which the place of effective management (or central management and control), of the parent-company or headquarter is located and in which this company is subject to corporation tax before entering the pilot scheme. In the case of most SMEs this will correspond to the seat of the parent-company, i.e. the place of its registered office. The place of effective management of the group members thus ceases to be a criterion for establishing their fiscal residence. Generally, in application of this rule it should be easy to identify the "Home State" for most SMEs. The smaller and more personal nature of ownership and management of SMEs will usually mean that the Home State is readily identified with the state of residence of the owners/managers. If there are problems in this respect, the tax administrations of the Member States in which the group is active have to come to a common agreement on the Home State; otherwise the company cannot participate in the pilot scheme.

PROVISIONS FOR SPECIFIC CASES AND ANTI-AVOIDANCE RULES

Evidently the pilot scheme has to include rules for dealing with exceptional cases. The following is suggested:

- A business which, while participating in the pilot project, organically grows by performing its proper commercial activities beyond the limits set out in the SME definition should not for this reason be excluded from the project.
- A change of ownership does not automatically lead to an exclusion of the participating company, unless it becomes part of a larger grouping and thus violates the above SME definition.
- One-off transactions and 'abnormal' business fluctuations in turnover, for instance where a large capital asset is disposed of, should not automatically lead to an exclusion of the participating company (or the "abnormal" disposal should be excluded from the turnover requirements).
- Mergers and acquisitions which do not affect the constitutive elements of the pilot scheme (SME definition; determination of Home State etc.) should not automatically lead to an exclusion of the participating company. The responsible tax administrations will however have to re-assess whether the prerequisites for participating in the scheme are still met under the new group structure.

The change of the Home State of a company as determined at the start of the 5 years test period should in principle not be possible. The (anyway highly unlikely) transfer of the company's seat to another Member State would lead to the termination of the pilot scheme and the application of the relevant national tax rules. The same would apply in a merger situation, if the merger leads to a change in the place of effective management (or central management and control) of the parent company. The transfer of assets between (i) the headquarter and the permanent establishment or (ii) the parent company and subsidiary in another Member State under the pilot scheme is generally possible under the domestic

(group) taxation rules of the Home State and will thus not give rise to a taxable event. In case (i) this usually even is the case for cross-border transactions (deferral of taxation). The participating companies are however required to establish, in collaboration with the responsible tax authorities, the book value and the market value of the transferred asset so as to make it possible to tax the transfer according to the current 'normal' rules if the pilot scheme is not prolonged or if the asset is sold (i.e. "freezing" of the position and tax deferral).

The decision by a company to take part in the pilot scheme should in principle be binding for the entire 5 year period (or for a shorter period until the pre-fixed end of the pilot scheme). If a company insists on ending the application of the scheme before the expiry of the five years period, this shall be possible but subjected to a re-assessment of the tax years under the pilot scheme and retroactive application of the "traditional" rules.

The general anti-abuse rules (vis-à-vis non-participating Member States³ and third countries) of the residence state for every group unit apply in order to forestall possibilities of "rule shopping". Moreover, only SMEs which exist and are tax resident in the 'Home State' for at least two years should be allowed to participate in the scheme. Finally, companies which are subject to preferential regimes (e.g. 100% tax credits) should not be allowed to take part in the pilot scheme.

TAX ASSESSMENT AND ADMINISTRATIVE ASPECTS

Participating companies would be obliged to file a tax return only in their home state. The responsible tax administrations of the other states concerned would receive copies of this tax declaration and the relevant annexes (e.g. balance sheets, profit/loss account etc.). There should not be any systematic requirement for translation but tax administrations could request that key documents are provided in the national language or another accessible language at the expense of the taxpayer. In many cases, these obligations could require a certain restructuring of any group in-house tax compliance functions.

The parent company will compute the combined profits of the group (under the rules of its residence 'Home State') and allocate those profits among the group members according to the pre-established formula. The figures of the various allocation criteria are reported to all Member States' tax authorities. The payment of the tax will be made by the respective group unit in its residence (Host) State. The general rules for mutual assistance and administrative co-operation in the EU apply. In case of litigation it would in principle be the rules of the residence state of a Home State group member company that would apply. The Commission and participating Member States create a monitoring group for supervising the pilot scheme, considering possible practical problems and assessing its success.

PROCEDURAL ASPECTS AND APPLICATION FOR PARTICIPATION IN THE PILOT SCHEME

In procedural terms it is expected that the Commission would issue a recommendation on the basis of which Member States would, applying the principle of mutual recognition embedded in the Home State Taxation approach, prepare and conclude a bilateral or

³ This obviously only holds true to the extent that these are compatible with the EU Treaty. The application of such rules in the context of the pilot scheme would in no case and by no means prejudice any position or decision to be taken by the Commission or any other institution in this area.

multilateral agreement allowing interested companies to participate in the Home State Taxation pilot scheme. The Member States concerned would then implement the agreement domestically following their national laws and customs. On this basis, the tax administrations of interested Member States could then 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 would have to file their "application" to take part in the pilot scheme with their usual counter-parts in the tax administrations of their Home States and these would be obliged to inform and consult the tax administrations of the other Member States concerned. A decision on the application should be jointly given within a reasonable period of time, e.g. two months.

FORMULARY APPORTIONMENT

For the purpose of this relatively small-scale pilot scheme it is suggested to use a simple formula for apportioning the tax base between the participating Member States on a trial basis. That could be either payroll (or alternatively the number of employees) or a three factor-formula (1/3rd each for payroll, sales, property of the SME in the countries concerned). Depending on the formula chosen it will be necessary to develop commonly accepted and practically operational definitions of the factors used in the apportionment formula. The Commission services are currently working on these issues.

The Home State Taxation system implies that the parent-company concerned uses the tax declaration forms of the Home State for combining and reporting its taxable activities in all Member States concerned. These do not include the necessary information on the apportionment factors. An appropriate (simple) form for declaring these in an annex to the tax declaration will therefore have to be devised.

THIRD COUNTRY ISSUES

Given the narrow scope of the pilot scheme it is highly unlikely that SMEs headquartered in third countries would apply to take part (for their EU-wide activities in an EU group, attributing the head office function to one subsidiary for the sub-subsidiaries) or that SMEs with indirect ownership via third countries could qualify for the pilot (parent company in Member States with subsidiary in third country which holds (sub-) subsidiary in Member States).

Third-country income (dividends, interests, royalties, income from immovable property etc.) of the group members falls outside the scope of the pilot scheme and would have to be accounted for under the normal rules. In other words, foreign source income would be added to the income of the group member after apportionment. This could however imply that more than one tax declaration, that of the home state and one in the host state for specific income items have to be filed.

The pilot scheme does not require any immediate changes to Member States' double taxation treaties with third countries. As each member of the 'Home State group' remains taxpayer in its residence country, the respective treaties will continue to apply. Most of the complex technical issues, for instance regarding third country dividends and branches, would in any event be outside its scope.

OTHER TECHNICAL ISSUES

Theoretically, the implementation of the pilot scheme could give rise to a number of additional technical issues concerning relatively complex questions relating to the application of double-taxation treaties, the treatment of dividend payments, the correct application of withholding taxes or the handling of transfer pricing disputes. Under the conditions of the pilot under consideration these are however rather unlikely cases. Moreover, the Commission services are convinced, that even if such problems came up, practical solutions would be available. More detailed information on these is available on request.

ECONOMIC IMPACT ASSESSMENT

Commission research on SMEs in the EU shows that only very small numbers of SMEs are currently active in Member States other than their own. The pilot scheme seeks to change this and help SMEs to participate in the opportunities of the Internal Market more easily by simplifying the relevant corporate tax rules and reducing the related compliance costs. The implementation of the pilot scheme would improve their business conditions and foster their survival rate and development possibilities via cross-border expansion in the Internal Market, thus generating beneficial growth and employment effects. The revenue consequences of the scheme for Member States would depend on its precise design, the number of participating SMEs and, not least, the details of the apportionment system chosen. Based on the statistical figures of SMEs which are internationally active and bearing in mind the very small proportion of corporate taxes paid by SMEs domestically, the amount of tax 'at stake' for Member States can safely be expected to be very low.

One of the main criticisms of Member State tax administrations of the proposed pilot scheme is the claim that the expected benefits arising from the scheme would not outweigh the administrative and other costs associated with its introduction. Furthermore, under internal Commission rules the expected impact of the scheme needs to be assessed before the actual initiative is launched ("extended impact assessment"). Therefore, it would in particular be desirable to establish a useful set of basic data for these works as soon as possible. The Commission services have started working on these questions and some data are available with publicly available statistics, including those published by the Commission Statistical Office itself. Most of the data are, however, if at all, only available at the level of Member States or with businesses. Business' active collaboration on assessing the expected economic impact of the pilot scheme and provision of input into the necessary data collection is therefore necessary. In a nutshell, the Commission services would need to know the extent to which the proposed pilot scheme would reduce the tax-induced costs of setting up a subsidiary or permanent establishment in another Member State. Would the scheme lead SMEs to establish themselves in other Member States where they would not do so in absence of the pilot scheme?