ETAF
European Tax Adviser Federation

ETAF feedback on the proposal for a Head Office Tax system for SMEs

As part of its “SMEs relief package”, the European Commission released on 12 September 2023 a proposal for a directive establishing a Head Office Tax (HOT) system for micro, small and medium sized enterprises.

In a nutshell, the proposal aims at giving SMEs operating cross-border through permanent establishments the option to interact with only one tax administration – that of the Head Office – instead of having to comply with multiple tax systems. SMEs would therefore calculate their taxes based only on the tax rules of the Member State of their Head Office. SMEs would file one single tax return with the tax administration of their Head Office, which would then share this return with the other Member States where the SME is operating. The Member State of the Head Office would subsequently transfer any resulting tax revenues to the countries where the permanent establishments are located. Estimated savings for EU SMEs could range, according to the Commission, from 1.3 billion € per year to 3.4 billion € per year.

ETAF generally welcomes any initiative which would effectively simplify tax processes and reduce compliance costs for SMEs. As a preliminary comment, we would like to encourage the Commission to pursue a broader legislative agenda to support SMEs and to reduce administrative burden.

We recognize the potential of the HOT initiative, especially for SMEs that may be planning to expand across the borders and may have been held back by the perspective of high compliance costs.

However, as it stands, we have some concerns about how the proposed HOT initiative would work in practice and the unintended effects it could generate.

I. Recommendations on the scope and applicability

a. Extension of the scope

The scope of the proposed rules is limited to standalone SMEs that operate exclusively through permanent establishments in one or more Member States. The rules would not apply to SME groups with one or more subsidiaries in another EU Member State.

From ETAF's view, the scope of the proposed directive is too narrow and will not allow many SMEs to benefit from this relief measure.

The Commission assumes that SMEs will mainly operate in the form of permanent establishments in the initial phase of their international expansion without setting up legally independent subsidiaries abroad. However, practice shows that SMEs regularly operate through subsidiaries in the initial phase of their internationalisation, be it for reasons of visibility on the market or for competition and labour law considerations.

As shown in the impact assessment report accompanying the proposal, one of the options originally considered by the Commission was the application of the simplified taxation system to SMEs with permanent establishments and subsidiaries in other EU Member States. We regret that this option has not been pursued.

Instead, we fear that the approach chosen by the European Commission risks influencing the business models of SMEs and potentially impairing their growth.

We would therefore recommend extending the scope of the directive to include SME groups with subsidiaries in other Member States. Moreover, rather than determining the applicability of the directive by referring to the form of organisation, we believe that a reference to the financial thresholds would be more appropriate.

In addition, the directive should also apply to sole proprietors or to natural persons with profits income, who can also operate in other Member States through permanent establishments and would greatly benefit a head office tax system as well.

b. Restriction of eligibility requirements

In general, we find the eligibility requirements appropriate. However, it remains questionable whether such restrictive provisions are necessary and whether the provisions will really prevent abuse and deter potential tax planning practices, as the Commission is justifying.

In particular, it is not obvious which possible tax planning practices are to be prevented by article 4, paragraph 1. (a), which requires that the joint turnover of the permanent establishments did not exceed, for the last two fiscal years, an amount equal to double the turnover generated by the head office. For this reason, we would suggest withdrawing this provision.

Ultimately, we would like to recall that the prevention of abuse and the deterrence of possible tax planning practices is not – and should not become – the main objective of this directive. Rather, the main goal should be to give SMEs the opportunity to operate across borders in a simplified manner.

c. Review the timing for notifying the opt-in

According to the proposal, the SME which opts to apply the head office taxation rules to its permanent establishments shall notify its choice to the filing authority at least three months before the end of the fiscal year preceding the fiscal year in which it wishes to start applying the new rules.

In ETAF's view, this timing should be reconsidered and extended until at least the end of the fiscal year in which that SME wishes to start applying the head office taxation rules. Otherwise, it would *de facto* prevent SMEs which established a permanent establishment in a fiscal year from opting to the head office taxation in this same fiscal year.

d. Renewal and termination of the option

The renewal of the option is also confined by strict eligibility requirements. In particular, the proposal states that the option to exercise HOT rules shall last for five years, unless the joint turnover of the permanent establishments becomes at least triple of the head office's turnover (even if the whole company is still an SME), in which case the HOT rules will cease to apply (article 8 (b)).

The head office will also not be entitled to renew the option if during the five-year period when head office taxation rules initially applied, for any two fiscal years taken separately, the joint turnover of the permanent establishments exceeded an amount which is equal to double the turnover of the Head Office (article 10 (a)).

We believe that these measures could impose artificial barriers to the growth potential of the company and should therefore be withdrawn.

In our understanding, the HOT option will automatically end after five years if the SME does not actively renew its application. To save even more compliance costs for SMEs, we recommend introducing an automatic renewal after five years and a possibility of actively opt-out from the measure.

II. Comments on the functioning of the one-stop shop

a. Possible taxation conflicts

The proposal foresees a one-stop shop that will enable in-scope SMEs to interact only with the tax administration of the Member State of their head office both for the procedure to opt in and for filing obligations and paying taxes.

In principle, we very much welcome this measure, which has a real potential of compliance costs saving for SMEs, however, we expect some problems to arise when it comes to the effective exchange of necessary tax information between Member States.

Moreover, a prerequisite to the HOT system is the need for Member States to agree on allocating the right to establish a taxable base to another Member State. Taxation remaining a national sovereignty issue, we expect several EU countries to oppose this. In fact, one ETAF member already expressed serious concerns about the loss of control of its country in determining the taxable base as well as a possible disequilibrium between big and small European countries.

In addition, the latest OECD Mutual Agreement Procedure (MAP) statistics show that conflicts regarding the allocation of permanent establishment profits (in addition to transfer pricing conflicts) are at the top of the list of mutual agreement procedures to be conducted. National profit determination rules can never be the subject of mutual agreement or arbitration proceedings. Therefore, it is expected that the directive will neither reduce nor eliminate taxation conflicts.

b. Information included in the HOT tax return

Concerning the information included in the HOT tax return, we recommend withdrawing the terms “assets and liabilities” in article 11, paragraph 3 (a) of the proposal. These terms suggest an obligation to keep accounts for permanent establishments. However, such an obligation would pose considerable problems in practice as the permanent establishments are only a construction for tax purposes and not an accounting concept.

Indeed, the earnings and expenses are allocated between the permanent establishments and the head office only for tax purposes and separate accounts are regularly not prepared for permanent establishments.

III. Practical problems foreseen with audits and appeals

a. Concerning audits by the home state and joint audits

According to the proposal, each Member State would remain competent for audits of permanent establishments in their jurisdiction. Member States would also be able to request joint audits that obligate the addressed Member State to participate.

Our members expect some practical difficulties for their national tax authorities to audit permanent establishments for which the taxable base was established according to another’s jurisdiction legislation. This would require tax inspectors to acquire in a short period of time significant knowledge of the tax laws of other Member States. We also fear that this approach may leave space for abuses.

b. Concerning appeals by the host state

We welcome the possibility given to the host state to appeal the decisions of the home state regarding the tax base determination. However, to have a fully-fledged one-stop shop solution, we believe that the possibilities of the host state’s tax administrations to appeal against the decisions of the head office country should be limited and the competencies between the host state and the home state should be better delineated.

In particular, we deem it necessary that one of the sates, preferably the home state, has the final say in appeals and audits. Otherwise, these overlapping competencies could lead to further international tax disputes.

IV. Risk of distortion of competition

The Commission explains that it is inherent that such an optional application of the rules may, in limited instances, create risks for the distortion of competition because comparable businesses may end up being subject to different taxation rules. However, in its view, the benefits will clearly outweigh those risks, and in particular, the system compensates for the additional and significant tax compliance costs that those SMEs with permanent establishment would otherwise have incurred.

Our members generally view positively the fact that the HOT rules are designed as an option and that each SME is therefore free to decide to make use of it or not. However, some of them, have expressed concerns about a possible risk of distortion of competition and recommend carrying out further impact analysis to see if the risk of distortion of competition is indeed outweighed by the advantages of the proposed directive.

Notes
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About ETAF
The European Tax Adviser Federation (ETAF) is a European umbrella organisation for tax professionals whose activities are regulated by law. It is set as an international not-for-profit organisation (AISBL) governed by Belgian law, based in Brussels and was launched on 15th December 2015. It represents more than 215 000 tax professionals from France, Germany, Belgium, Romania, Hungary, Austria and Croatia. ETAF is a registered organisation in the EU Transparency Register, with the register identification number 760084520382-92.