European Commission publishes Head Office Tax system for SMEs

European Commission – Fair taxation – Business in Europe – Framework for Income Taxation – Head Office – Permanent Establishment - SME – BEFIT

On September 12, 2023, the European Commission (EC) issued a proposal for a Council Directive on establishing a Head Office Tax (HOT) system for micro, small and medium sized enterprises (SME) and amending Directive 2011/16/EU.

The Directive proposal allows certain standalone SME entities with permanent establishments in other EU Member States to calculate their tax liability based only on the tax rules of the Member State of their head office. Qualifying SMEs would also only need to file a single tax return with the tax administration of their head office. This return would then be shared with other Member States where the permanent establishments are located, with any resulting tax revenues also transferred from the head office Member State to the PE Member State(s).

The proposal was issued alongside the proposal for a Council Directive on Business in Europe: Framework for Income Taxation (BEFIT) and a proposal for a Council Directive on transfer pricing. For more details on these proposals, please refer to Euro Tax Flash Issue 521.

Background

The EC's SME relief initiative was first proposed by the Commission on May 18, 2021, as part of its Communication on Business Taxation for the 21st Century to promote a robust, efficient and fair business tax system in the EU. In this context, the Commission announced a proposal for a new framework for income taxation for businesses to (i) boost the competitiveness of the single market, (ii) reduce compliance costs (including for SMEs) and to support investment in the EU.

As part of the 2022 State of the Union Address, the President of the European Commission (Ursula von der Leyen) informed the European Parliament about the EC's intention to put forward a relief package for small and mid-sized enterprises (SME) to reduce bureaucracy and simplify doing business in the EU.

As part of the 2022 BEFIT consultation, the EC stressed the issue of complexity and high costs that businesses, notably those with cross-border activities, face as a result of having to comply with 27 different corporate tax systems in the EU. The BEFIT consultation documents therefore proposed common rules for the determination of the corporate tax base of EU-based entities that are part of a group with global consolidated revenues above a certain threshold. In this context, the EC also asked for views on whether a common corporate tax system should be available to SMEs with cross-border activities.

Head Office Tax system proposal by the European Commission

The proposed Directive is structured into three chapters; starting with general provisions on scope and definitions, moving to the provisions relating the HOT system and then finishing with provisions covering the transposition of the proposed Directive into the local laws of EU Member States.

Scope and eligibility requirements

The Directive would apply to certain EU-based standalone SMEs that operate exclusively through PEs in one or more Member States. The proposed Directive's scope would therefore not cover SME groups that have subsidiaries in another EU Member State.

The Directive would also not apply where (i) the SME is part of a consolidated group for financial accounting purposes, (ii) where it would be considered as an associated enterprise within as defined in Directive 2013/34/EU[1] or (iii) a linked enterprise within the meaning of Article 3(3) of Commission Recommendation 2003/361/EC[2].

In addition, the SME would not be able to benefit from the Directive:

- Where, for the previous two fiscal years, the joint turnover of its PEs exceeds an amount equal to double the turnover generated by the head office.
- Where, during the two previous fiscal years, it has not been resident for tax purposes in the head office Member State.
- Where it has not qualified as an SME for the previous two fiscal years.
- To the extent it derives income from shipping activities that is subject to a tonnage tax regime.

Calculation of the PE tax liability at head office level

If eligible, an SME would have the option to calculate the taxable results of its PE(s) based only on the taxation rules of the Member State of its head office.

However, the taxable results of the PE(s) would remain subject to the tax rate of the Member State in which the PE is located (host Member States). As such, the Directive would not affect the right of the host Member State to determine the applicable tax rate or the applicability of a bilateral tax treaty.

[1] Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EE.

[2] Commission Recommendation (2003/361/EC) of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (notified under document number C(2003) 1422).

In order to apply the head office taxation system, an SME must make a five-year election. The head office tax rules would need to be applied during this period unless (i) the SME transfers its tax residence out of the head office Member State or (ii) the joint turnover of its PEs exceeds an amount equal to three times the turnover of the head office. At the end of a five-year period, an SME would have the option to renew their choice for a further five years, provided that the SME continues to satisfy the eligibility requirements.

Administration

The proposal requires the head office to notify the competent tax authority in its Member State (filing authority) that an election is being made at least three months before the applicable fiscal year commences.

Where the head office taxation rules apply, the SME would file a single return with the head office Member State (i.e., a one-stop shop would be established from a payment and filing compliance perspective). The tax returns for its PEs would require information to be provided regarding the tax liability and a breakdown of the taxable income / loss in the head office Member State and in each host Member State. If separate financial accounts are not prepared for a PE, the tax return would also need to provide details of the assets, liabilities and profits attributable to the PE.

Next steps

It is expected that the EC will launch a public consultation seeking feedback from interested stakeholders on both of the proposed Directives. Based on the general process, the public consultation would run for an eight-week feedback period starting from September 12, 2023, but would be extended for each day until the proposal is available in all EU languages.

Considering that the legal basis for the EC's proposal is Article 115 of the Treaty on the Functioning of the EU (TFEU), the Directive requires unanimous approval in the Council. In addition, the Council would only be allowed to adopt the text once the Parliament and any relevant Committees have given their (non-binding) opinions.

Where the Directive is approved in the Council, it would enter into force on the twentieth day following that of its publication in the Official Journal of the EU. The Commission proposes that Member States should transpose the rules into domestic law by December 31, 2025 and that the provisions of the Directive should apply as of January 1, 2026.

ETC Comment

While the SME relief package was previously announced in the context of the BEFIT initiative, it is noteworthy that the proposal for a head office taxation regime was issued separately from the BEFIT proposal.

According to the Q&A webpage, the head office taxation proposal is aimed at simplifying tax rules for SMEs during their early stages of expansion, while the BEFIT proposal is primarily aimed at large groups operating across the EU. It is noted that the two proposals are complementary in nature, as a successful SME may outgrow the scope of the head office taxation rules, but could potentially then transition into the BEFIT regime on an elective basis.

Similar to the BEFIT Directive, the head office taxation system proposal would require unanimous approval in the Council. As such, the successful adoption of this proposal may depend on how Member States view the impact of the proposal on their economies. The proposal may also be subject to certain amendments and adjustments, as the political debate develops.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

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