



Faculty of Taxation

## **TAXREP 12/03**

### **The experimental application of “Home State Taxation” to small and medium-sized enterprises in the EU Comments on the Consultation Paper issued by the European Commission**

*Memorandum submitted in April 2003 by the Tax Faculty of the Institute of  
Chartered Accountants in England and Wales to the European Commission in  
response to the Consultation Paper issued in January 2003*

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# Tax Representation

## **The experimental application of “Home State Taxation” to small and medium-sized enterprises in the EU Comments on the Consultation Paper issued by the European Commission**

### **INTRODUCTION**

1. We welcome the opportunity to comment on the Consultation Paper issued by the European Commission in January 2003. We have set out our general comments on the paper in paragraphs 5 to 11 below. We have also answered the specific question in the paper in the Appendix.

### **WHO WE ARE**

2. The Institute is the largest accountancy body in Europe, with more than 123,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy (which includes taxation).
4. The Tax Faculty is the focus for tax within the Institute. It is responsible for technical tax submissions on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter 'TAXline' to more than 11,000 members of the Institute who pay an additional subscription.

### **GENERAL COMMENTS**

5. We welcome the opportunity to consider ways of reducing the burdens placed on businesses which wish to operate in European Union member states other than their home state. The proposals contained in the document are a helpful contribution to the real issues raised by the difficulty of doing business in other EU member states.

It will be important that any system of Home State Taxation (HST) is not vulnerable to a legal challenge under the European Treaty. We appreciate that the paper (at paragraph 4.1.2) recognises the competition and discrimination issues. We also note the following comments in section 2.20 of SO Lodin and M Gammie's book on Home State Taxation:

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‘An unavoidable consequence of HST is that enterprises conducting similar activities in the same Member State may face different tax rules and have different effective tax burdens.’

These issues need to be clarified and where necessary put beyond doubt because if there is serious doubt about the legality of the scheme, it could lead to litigation before the European Court of Justice (ECJ) and undermine the scheme.

6. We are also concerned about the practicability and acceptability of domestic Revenue authorities allocating “profit” between the operations of a group of companies’ in different EU countries. In practice, this allocation may not be easy to achieve.
7. The potential problems of allocation contrast with the traditional approach to ensure that the appropriate commercial profit is taxed in different jurisdictions, namely transfer pricing rules. The advantage of the transfer pricing approach is that the rules and procedures are well established and understood to all the relevant parties.
8. Given the disparity between the UK and Irish rates of corporation tax, we question whether the UK authorities would be particularly attracted to the idea (as suggested in paragraph 4.4.2) to enter into a pilot scheme with Ireland. The tax rate in Ireland was progressively reduced to 12.5% with effect from January 2003 and as a result the UK Government has recently removed Ireland from the CFC Exempted Countries list. The UK Government would, we are sure, want a robust system to ensure that a group operating in Ireland and the UK cannot, under the proposed pilot scheme, cause a disproportionate amount of the aggregate profit to fall to be taxed in Ireland at the low 12.5% rate.
9. We have recently made representations to the European Commission suggesting that the removal of Ireland from the CFC Exempted Countries list is in contravention of Article 43 of the European Treaty. This is because it may constitute a restriction on the freedom of establishment of nationals of a member state in the territory of another member state.
10. We are also conscious that one of the main burdens of compliance is not the preparation of accounts and computations but in dealing with the tax authorities afterwards. Substantial progress might be possible in that direction by EU tax authorities agreeing to rely on the home-state authority’s tax audit and not to enquire too closely into intra-EU transfer pricing. That would be a much simpler approach to reducing compliance burdens.
11. We would be delighted to discuss the issues raised in your paper in more detail and more generally how the burdens on businesses wishing to operate in other EU member states can be reduced.

IKY  
30 April 2003

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## Appendix

### Answers to specific question in the Consultative Document

- 1 Would respondents from the business community (and notably the bodies representing SME interests) be prepared to co-operate on the design and testing of a ‘pilot scheme’?**

For reasons set out in the main response we are sceptical as to the acceptability of the Home State Taxation scheme to the UK and its most natural partner for a pilot scheme, Ireland. Nevertheless the Tax Faculty would be interested in assisting the European Commission in the design and testing of a ‘pilot scheme’ if such a scheme was to be pursued.

- 2 Do respondents think that the arrangement under negotiations between Germany and Netherlands could be usefully extended to other regions?**

We would want to have more detailed information about the scheme before we could form a judgement as to its likely, successful, implementation to other geographic areas.

- 3 Would moving to ‘Home State Taxation’ for the taxation of small and medium-sized enterprises in the Internal Market deliver real simplification benefits and efficiency gains?**

For the reasons set out in the main response we are not yet convinced that it would.

- 4 What are respondents’ views on the basic approach of the pilot scheme?**

While we appreciate the theoretical attraction of the scheme we are concerned that a number of practical difficulties are not yet addressed. Apart from the appropriate allocation of profits between operations in different member countries we are also concerned about the treatment of non-EU activities and transactions.

- 5 Is it considered necessary or suitable that in any event a SME, which fulfils its tax formalities under ‘home state rules’ with the tax authorities of its ‘home country’ only, still introduces a pro-forma declaration in all countries in which it is active?**

We believe that all participating countries would want to know that they had some means whereby they could understand how the profits relevant to operations in their territory had been computed. Whether this is by way of a pro forma declaration we do not at this stage have a firm view.

- 6 What are respondents’ views on the possibility of a purely theoretical/hypothetical pilot scheme?**

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We believe that such a scheme is likely to bring out some of the practical difficulties of the proposal and give some indication as to how difficult it would be to overcome them.

**7 Is it considered feasible in practice to go beyond the practical testing of the approach in selected sample firms and implement a far-reaching and broad ‘pilot scheme’?**

We believe that more detailed testing is required before a “far reaching and broad” pilot scheme is considered.

**8 Would respondents consider that the SME-pilot scheme gives rise to serious discrimination and/or competition problems? If yes, could respondents indicate in which precise area/situation they see such problems?**

For the reasons outlined in the main response we are concerned that the pilot scheme might give rise to serious discrimination problems. Suppose (say) a French subsidiary of a German company elects home state tax. Assume the German tax base produces a greater taxable base than the French does. So, under home state tax, a French subsidiary of a German parent pays more tax than a stand-alone French company, given that both French companies pay at the French Corporation Tax rate. This would appear to be unjustifiable unequal treatment by virtue of cross border ownership of the French company by another EU country company, hence illegal under current law (see ECJ decisions in, for example, *Hoechst (Case C397-98)*).

**9 What are respondents’ views on the potential infringement of the principle of neutrality in taxation (e.g. vis-à-vis the legal form of business)**

In principle we believe that tax systems in the EU should be neutral as to the legal form of the business. However, if we take the example of the UK, recent tax developments have exacerbated the differences between operating a business through a company as compared to operating as an unincorporated business.

**10 Is it considered desirable or necessary to develop a proper definition of SMEs for the purposes of the pilot scheme?**

We cannot see that the scheme is going to be acceptable to member states unless there is a standard definition of SME and it would seem appropriate for this to be accepted before a pilot scheme is put in place.

**11 What are respondents’ views on the idea to apply the mutual recognition principle to the definition of SMEs (in order to take country-specific conditions into account)?**

We agree with the comments in the Consultation Paper that it is unlikely that the mutual recognition principle to the definition of SMEs would be acceptable to Member States, as it would imply that competing SMEs of identical size would be treated differently.

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- 12 Of the existing SME definitions identified, which would be the most useful for the purpose of the pilot scheme?**

We think the definition referred to in section 4.2.1 should be adopted.

- 13 Which ‘buffer rules’ and transition arrangements would be desirable for dealing with borderline situations?**

It would be undesirable if the rules had the effect that companies move into and out of the scheme from year to year. One possibility would be to require that companies must come within the scheme for a minimum period, say three years, and that they would only be excluded from the scheme within that period if they exceeded the size parameters by a significant margin.

- 14 Is it considered necessary to define the scope of the pilot scheme by having recourse to additional criteria (other than size)?**

We have answered the specific questions under 15-17 below.

- 15 What are respondents’ views on the introduction of a time limit for businesses participating in the pilot scheme?**

If a suitable scheme can be devised then we cannot see that it would be appropriate to restrict its use by a particular company to a couple of years.

- 16 Are there any sectors, which could be usefully identified for defining the scope of the pilot scheme?**

We cannot see that there are any sectors that particularly lend themselves to the scheme and, indeed, the remarks in the Consultation Paper deal with sectors which do generally have special tax treatment but which do not generally have many SMEs operating within that sector.

- 17 What are respondents’ views on the treatment of activities in third countries or income therefrom? Is it considered suitable to provide for a territorial limitation of the pilot scheme?**

In the case of a group, subsidiaries outside the participating States would automatically be excluded from Home State Taxation.

- 18 Is it considered necessary and feasible to include partnerships in the scope of the pilot scheme?**

We see no reason in principle to exclude unincorporated businesses but agree that the issues raised will be complicated. Practically, we suspect that the UK would probably exclude partnerships from any pilot scheme in view of the various tax incentives aimed at incorporated businesses, for example the nil rate of corporation tax on business profits up to £10,000.

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- 19 If partnerships would be included in the pilot scheme's scope, should this be done under a "tax treaty approach" or under a "consolidation approach"?**

We believe that the position of partnerships needs to be analysed in more depth (as noted in the paper) before this question can be answered.

- 20 Are there significant tax incentives, which are relevant for SMEs, that would impact on the feasibility of the proposed pilot scheme? If yes, which and in what countries?**

In practice this is likely to be a major consideration. The UK has a number of incentives aimed at SMEs, including enhanced capital allowances on plant and machinery for all SMEs and 100% allowances for investment in ICT (Information, Communication and Telephonic) equipment available for small enterprises.

- 21 Is it considered necessary to provide for special rules on the treatment of tax incentives (e.g. by transforming these, within the scope of the pilot scheme, into tax credits)?**

We believe that this would probably be necessary in order to encourage use of the scheme but it may give rise to problems with member states. Further work needs to be undertaken to analyse the problem.

- 22 What are respondents' views on the proposed exclusion of VAT from the range of taxes covered by the pilot scheme?**

We agree that VAT should be excluded from the pilot scheme.

- 23 What are respondents' views on the proposed inclusion of local profit taxes in the range of taxes covered by the pilot scheme?**

We believe that technically the inclusion of local profits taxes do not of themselves cause additional problems for home state taxation. However, problems will arise where local taxes are not computed on a profits basis but some other method, e.g. property valuations. More research should be undertaken into the nature and level of local taxes.

- 24 What are respondents' views on the proposed means for including local profits taxes in the pilot scheme? Are there country-specific aspects to be taken into account and, if so, which?**

See comments in question 23 above. In answer to the second part of the question, the UK has a local 'tax' system based on property.

- 25 If a broad scope of the pilot scheme is being decided, is it considered necessary to provide for a revenue or base allocation mechanism? If so, which would be preferable?**



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We do not have any firm views on this at the moment as would want to see how the pilot scheme affected particular situations to have a better understanding of the practical implications of Home State Taxation.

- 26 Would there be particular difficulties in collecting the data necessary for applying an apportionment formula based on ‘sales’ or one based on ‘payroll’?**

Within a group of companies the individual subsidiaries would be preparing accounts so we believe the data should be readily available. However, whether either of these methods is a suitable basis for allocation is a question which we would need to examine further in due course.

- 27 Would there be particular difficulties in collecting the data necessary for applying an apportionment formula based on ‘value added’?**

This is likely to be more difficult to determine than applying a formula based on sales or payroll.

- 28 What are respondents’ views on a direct revenue compensation mechanism between Member States?**

We believe this would be difficult to operate.

- 29 What are respondents’ views on the proposed intensification of mutual assistance and information exchange between tax administrations as well as the increase of joint audits?**

We believe much needs to be done to improve mutual confidence and co-operation between tax authorities.

- 30 Is it considered valuable to launch the pilot scheme even if it was not introduced in all Member States?**

We have a number of reservations about the scheme as expressed in the main body of this Tax Representation. If a pilot scheme were designed to give more information about some of the issues causing us general concern then we would not be averse to the launch of such a pilot scheme.

- 31 Is it considered necessary to provide a coherent EU wide framework for the pilot scheme which would set out the rules for all Member States, regardless of whether or not they implement the scheme in practice?**

We believe it would be best to start with a relatively local pilot scheme so that practical problems can be identified and potential solutions arrived at before the scheme is considered for extension to all Member States.

- 32 If an EU legal framework for the pilot schemes is being favoured, is it considered necessary to provide a legally binding instrument (which would fall under the control of the European Court of Justice)?**



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We feel it would be important for the system to be such that the ECJ is the final arbiter on whether the arrangements accord with the terms of the European Treaty. This implies that the scheme should be introduced by way of a Directive rather than a Commission Recommendation. As mentioned earlier in our response, it will be vital to ensure that the scheme is not vulnerable to a challenge under the EU Treaty.

**33 Are there any other issues which respondents wish to raise or comment on? If so, which?**

The issues raised in the paper are part of the wider question of reducing and removing barriers to doing business in other EU member states. Business tax issues are a major consideration but there are many other factors to be considered. These issues include, for example, the personal income tax and social security rules and associated payroll taxes. In addition, the different legal systems of the member state are a major barrier to encouraging smaller EU businesses to operate in other member states. In the longer term, it will be important for any proposals to reduce burdens on doing business in the EU to take account of all of these factors.