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Tax relief for SMEs in Europe: The EU Commission's Head Office Tax Directive

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Abbreviations

bn	billion
CIT	Corporate income tax
CC	Compliance costs
DTA	Double Taxation Agreement
e.g.	exempli gratia
EU	European Union
HOT	Head Office Taxation
i.e.	id est
PE	Permanent establishment
SMEs	Small and medium-sized enterprises
TFEU	Treaty on the Functioning of the European Union
TEU	Treaty on European Union
VAT	Valued added tax

1. Introduction

"*Small and medium-sized enterprises (SMEs) are central to Europe's economic and social fabric.*"[1] They are particularly important as they account for around 24 million companies and around 99 % of all companies in the European Union. SMEs provide almost two thirds of all jobs in the private sector and are therefore of crucial importance for the European Economy.[2]

This master's thesis will provide an overview of the existing difficulties for SMEs in cross-border activities with regard to the taxes to be paid in order to then analyze the European Commission's proposal for a directive on the establishment of a head office tax system for SMEs as well as its implementation and effectiveness. As part of a detailed analysis and evaluation of the proposal, the following questions should be answered: How did the European Commission's directive come about in the first place? What problem does the directive attempt to solve? What does the directive say? What are the challenges in implementing a uniform tax system for SMEs?

The following chapter will first give an overview of the importance of SMEs in the European economy and then take a closer look at the current challenges for SMEs in general and in cross-border activities.

1.1 Definition of SMEs

In order to gain a better understanding of the classification of SMEs in the context of their role for the European Union, it must first be defined what exactly SMEs are. Moreover, the definition is also important regarding whether a company receives access to finance and EU support programs specifically designed for these companies[3].

According to Article 2 (1) of the Commission's Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises SMEs are defined as follows: "*The category of micro, small and medium-sized enterprises (SMEs) is made up of enterprises which*

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[1] European Commission, 'Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – SME Relief Package' COM (2023) 535 final, 1.

[2] European Commission, *Annual Report on European SMEs 2022/2023 – SME Performance Review 2022/2023* (Publications Office of the European Union 2023), 3.

[3] European Commission, 'SME definition' <https://single-market-economy.ec.europa.eu/smes/sme-definition_en> accessed 23 July 2024.

employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million."[4] For enterprises, these are according Article 1 generally such entities that are *"[…] engaged in an economic activity, irrespective of its legal form. This includes, in particular, self-employed persons and family businesses engaged in craft or other activities, and partnerships or associations regularly engaged in an economic activity.*"[5] Thus, in order to be considered as a SME at all, it must first be clarified whether it is an enterprise (cf. Article 1), whether it meets the requirements of Article 2 (1) and also whether it does not have access to significant additional resources, such as being owned by, linked to or partnered with a larger enterprise[6].

If the classification as an enterprise has been made due to an activity, which means that an entity carries out an economic activity in accordance with the above definition, it can therefore be checked whether the criteria of Article 2 (1) apply. Accordingly, the company must employ fewer than 250 people and have an annual turnover of no more than € 50 million or an annual balance sheet total of no more than € 43 million. Further distinctions can be made between micro, small and medium-sized enterprises, whereby small enterprises employ fewer than ten people and the limit for annual turnover or balance sheet total is no more than € 2 million; small enterprises with fewer than 50 employees and an annual turnover or balance sheet total of no more than € 10 million; and medium-sized enterprises with fewer than 250 employees and an annual turnover of no more than € 50 million or an annual balance sheet total of no more than € 43 million.[7]

In the case that these criteria apply to a company, it is a small or medium-sized enterprise, i.e. SME.

1.2 Importance of SMEs in the European economy

With a market covering 99 % of all companies in the European Union, a total of 24 million companies, and providing two thirds of all jobs in the Union, SMEs are of great importance to the European economy[8].

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[4] European Commission, 'Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises' L 124/36, 39.
[5] ibid 39.
[6] European Commission, *User guide to the SME Definition* (Publications Office of the European Union 2020), 4.
[7] ibid 11.
[8] European Commission, *Annual Report on European SMEs 2022/2023 – SME Performance Review 2022/2023* (Publications Office of the European Union 2023), 3.

However, the economic role of SMEs differs within the various economic sectors. The importance of SMEs in the construction sector, accommodation and food service activities, and in services general is particularly significant, while areas such as manufacturing, wholesale and retail trade, energy and water supply are primarily dominated by large companies. But SMEs were able to generate around 78 % of turnover in their dominant sectors in 2021, while their share of employees was around 88 %. Although SMEs account for only 29 % of turnover in the sectors mentioned, their importance is due not only to their contribution to the economy but also to their role in job creation and thus in the functioning and stability of the European economy.[9]

In 2022, like in previous years, SMEs accounted for the majority of all employment in most sectors, especially in the areas of construction, accommodation and food services, real estate activities as well as professional, scientific and technical activities where they accounted for more than 80 %[10]. In total, around 84 million people were employed that year, accounting for 64,4 % of employment within the European Union. Thus, the number of people employed by SMEs increased by 2,4 % in 2022 compared to the previous year, although it should be noted that this is partly due to the recovery from the Covid-19 pandemic crisis. In any case, the numbers are still below the numbers before the pandemic in 2019 and SMEs have therefore not yet returned to the same level of performance.[11]

The abovementioned data shows the importance of SMEs for our European Economy. Not only do they represent the majority of companies in the Union, but they are also the main employer in the EU and therefore indispensable for the stability and functioning of the European economy.

1.3 Challenges faced by SMEs

Despite their great importance for the European Economy, SMEs have had to face difficult challenges in recent years, such as the Covid-19 pandemic and the resulting supply bottlenecks as well as the Russian war of aggression against Ukraine and the resulting higher energy costs,

[9] *Statistisches Bundesamt* (Destatis), 'SMEs generates 78 % of turnover in the economic sector of construction, accommodation and food services' (2024) <www.destatis.de/EN/Themes/Economic-Sectors-Enterprises/Enterprises/Small-Sized-Enterprises-Medium-Sized-Enterprises/small-medium-sized-enterprises-nd.html> accessed 23 July 2024.
[10] European Commission, *Annual Report on European SMEs 2022/2023 – SME Performance Review 2022/2023* (Publications Office of the European Union 2023), 13.
[11] ibid 3.

which have reduced the profitability of SMEs. SMEs have not been able yet to return to their pre-pandemic performance level.[12]

Initially, with the beginning of the Covid-19 pandemic in 2020 and the accompanying difficulties in the years that followed, SMEs experienced various hurdles. Especially after the immediate effects of the pandemic subsided in 2021, it was challenging to find and hire new employees in response to the resulting high demand while adapting to rising prices. With this hurdle barely overcome, SMEs were faced with rising energy and raw material prices as well as high inflation rates in the following year 2022.[13] The rise in inflation rates then also led to an increase in interest rates, making it more difficult for SMEs to access to finance. In combination with the termination of certain state financial aid provided during the pandemic, SMEs have come under severe pressure in recent years, which has threatened their growth. In addition to these already existing challenges, the Russian war of aggression against Ukraine led to an additional burden, which particularly affected SMEs with strong geographical and economic ties to one of these countries, but also those that were exposed to the resulting higher energy costs.[14]

Another significant hurdle for SMEs is their competitiveness and inadequate international presence, as their small size and therefore limited financial and personnel resources make it more difficult for them to enter new markets. Moreover, their size also has an impact on their research and development capacities and their ability to innovate, meaning that their products are less competitive on external markets, for example in the manufacturing industry, while their business performance is also below that of large companies. The situation for SMEs is made particularly difficult by three relevant factors: the availability of skilled labor, the difficulty to access finance, and regulations and administration by other states (e.g. taxes).[15]

These difficulties are challenges for SMEs to compete in an international market. Furthermore, these challenges also have an impact on the profitability and performance of SMEs and, in view of the importance of SMEs for the European Economy, also on the growth of the European market in global competition.

[12] European Commission, 'Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – SME Relief Package' COM (2023) 535 final, 2/3.
[13] European Commission, *Annual Report on European SMEs 2022/2023 – SME Performance Review 2022/2023* (Publications Office of the European Union 2023), 16.
[14] ibid 3.
[15] European Committee of the Regions, *EU policy framework on SMEs: state of play and challenges* (European Union 2019), 13/14.

1.4 Further procedure

This introduction shows in particular the importance of SMEs for the European economy, but also the problems they have had to face in the internal market in recent years. With its proposal for a directive of 12 September 2023 on the introduction of a head office taxation system for SMEs, the European Commission aims to address the abovementioned challenges faced by SMEs in complying with tax obligations when operating across borders. However, in addition to this proposal, the Commission also published two other proposals for directives, namely the so-called "Business in Europe: Framework for Income Taxation (BEFIT)" proposal and a proposal to harmonize transfer pricing rules in the EU and ensure a common approach to transfer pricing[16]. Overall, these three proposals are intended to address the current challenges in the area of corporate taxation[17]. In addition, the proposal for a directive on the introduction of head office-based taxation was published as part of an SME relief package, which also contains a proposal for a late payment Regulation and a number of measures to facilitate the work of SMEs, in particular to improve access to finance and skilled workforce and to support SMEs throughout their business lifecycle. In total, the EU Commission wants to create short-term relief, strengthen the competitiveness and resilience of SMEs in the long term and create a fair and friendly environment for SMEs.[18]

However, the following master's thesis will focus on the European Commission's proposal for a directive of 12 September 2023 on the introduction of a head office-based tax system for SMEs in order to be able to examine the proposed directive and the associated problems and challenges of implementation in detail.

2. Explanation of the problem

For a better understanding of the European Commission's proposal for a directive on the establishment of a head office tax system for SMEs, the underlying problem for SMEs in cross-border activities must first be fully understood. The following chapter will therefore provide a

[16] European Commission, 'New proposals to simplify tax rules and reduce compliance costs for cross-border businesses' (2023) <https://taxation-customs.ec.europa.eu/news/new-proposals-simplify-tax-rules-and-reduce-compliance-costs-cross-border-businesses-2023-09-12_en> accessed 23 July 2024.

[17] European Commission, 'Commission Staff Working Document – Subsidiarity Grid accompanying the documents – Proposal for a Council Directive on Business in Europe: Framework for Income Taxation; Proposal for a Council Directive on establishing a Head Office Tax system for micro, small and medium sized enterprises and amending Directive 2011/16/EU; and Proposal for a Council Directive on Transfer Pricing' SWD (2023) 301 final, 1.

[18] European Commission, 'Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – SME Relief Package' COM (2023) 535 final, 2.

brief overview of the current tax landscape for SMEs in order to then identify the core challenges and issues in cross-border taxation and the impact of existing tax systems on SMEs. In a final step, the need for tax harmonization within the European Union will be explained in more detail.

2.1 Overview of the current tax landscape for SMEs

To begin with, it is important to clarify what changes are necessary to promote the cross-border activities of SMEs. In order to answer that, it is important to know what the current tax landscape in the European Union looks like for SMEs.

There is currently no uniform system for corporate taxation in the EU, which in turn means that SMEs that want to operate cross-border have to deal with up to 27 different tax systems. The European Commission generally assumes that SMEs will mainly operate through permanent establishments (PE) at the start of a cross-border activity, since this is less costly in the beginning than setting up an independent subsidiary.[19] In contrast to a subsidiary, a PE is a legally dependent part of the company based in the home Member State, whereas a subsidiary is a legally independent part of the company and must be established in accordance with the regulations of the respective Member State[20]. If SMEs wish to operate cross-border and set up a permanent establishment in another Member State, they will also be subject to tax in that Member State[21].

Each of these 27 different tax systems has its own detailed specifications for the calculation of the national corporate income tax base of SMEs. However, this means that SMEs must familiarize themselves with the individual tax systems of the Member States in which they operate through a PE in order to be able to submit a tax return to the competent authority in the respective Member State. In this context, for example, the statutory tax rates can vary considerably between Member States, ranging from 10 % to 31.5 %. For cross-border activities of SMEs, countries also have a method for determining the tax liability of the company and the taxable portion of total income as well as any deduction of foreign expenses. There are also relief mechanisms such as an exemption or a tax credit, whereby the tax owed by the PE is taken into

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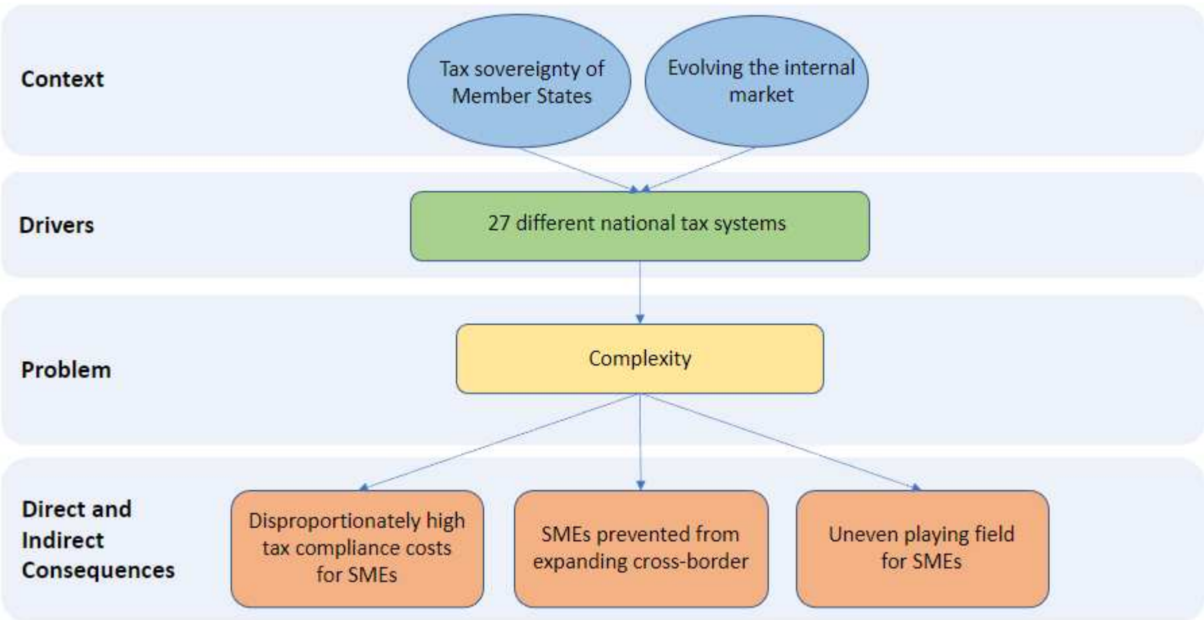
[19] Stefan Bendlinger, 'Einheitlicher Standard der Betriebsstätten-Ergebnisermittlung für KMU in der Europäischen Union' (2023) SWI 2023 <www.icon.at/fileadmin/media/News_Publikationen/Publikationen/Einheitlicher_Standard_der_Betriebsstaetten-Ergebnisermittlung_fuer_KMU_in_der_EU_Bendlinger_Stefan_swi-2023-10_0514-0525.pdf> accessed 23 July 2024, 517.
[20] Rödl & Partner, 'Permanent establishment versus subsidiary' <www.roedl.com/insights/corporate-control/permanent-establishment-vs-subsidiary> accessed 23 July 2024.
[21] European Commission, 'Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' COM (2023) 528 final, 1.

account against the tax owed by the head office, but this depends on the regulations of the individual Member States.[22]

Accordingly, this practice often requires SMEs to deal with several tax systems of different Member States and to comply with various regulations, which can lead to challenges for SMEs in particular, as will be discussed in more detail below. In addition, the following Figure 1 provides an overview of the basic problem of taxation for SMEs operating across borders.

Figure 1 – Problem Tree[23]



2.2 Core challenges and issues with cross-border taxation of SMEs

This chapter aims to explain in more detail how the current tax landscape described above affects the cross-border activities of SMEs, in particular with regard to the core challenges for cross-border activities in terms of SME taxation and the impact of existing tax systems on SMEs.

As already explained in chapter 2.1, when SMEs operate a permanent establishment in one of the Member States of the European Union, they must deal with the particular tax regulations of the state in which they wish to operate their PE. Therefore, SMEs must familiarize themselves

[22] European Commission, 'Commission Staff Working Document – Impact Assessment Report accompanying the document – Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' SWD (2023) 302 final, 5/6.
[23] ibid 5.

with the specific regulations (e.g. CIT, VAT, and income taxes) of the respective Member States.[24] Among other things, this is linked to the need to procure external consultants or to the additional workload of employees or even to the hiring of new staff, which in turn leads to new costs in the event of compliance. These compliance costs are a heavy burden on SMEs, particularly in view of their size and turnover.[25] Indeed, compliance costs do not refer to how much tax a company has to pay, but the cost of the measures to be taken for such compliance, such as financial and accounting planning, recording transactions, collecting and storing documents, filing returns and possibly conducting audits and litigation[26]. For 55 % of SMEs, this administrative burden is thus one of the core challenges in cross-border taxation[27].

The resulting problems, particularly in complying with the tax regulations of different jurisdictions in different states, lie primarily in the cost of such compliance, which amounts to 2.5 % of SMEs' turnover. In comparison, the cost of fulfilling tax obligations for large companies is only 0.7 % of their turnover.[28] This shows that although large enterprises have to pay higher amounts in relation to their turnover in order to comply with tax regulations, the relative burden for SMEs is higher, as the compliance costs are also partly fixed costs[29]. Despite the higher absolute cost of tax compliance for large enterprises, cross-border activities have almost no impact on large enterprises, according to a European Commission study on the cost of tax compliance for SMEs[30].

This study also shows the extent to which current tax systems affect SMEs differently from larger companies by assessing the tax compliance burden on SMEs. Thus, while the average company within the EU spends around 1.9 % of its turnover on tax compliance, such a relative proportion is 0.8 % for small companies and 0.3 % for medium-sized companies. These figures result from an analysis of the total costs of complying with tax obligations for all direct and indirect taxes in relation to the company's total turnover[31]. In particular, it shows that companies – depending on their size – can use their size advantage to ensure compliance with tax

[24] European Commission, 'Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' COM (2023) 528 final, 1.
[25] European Parliament, *Removal of taxation-based obstacles and distortions in the Single Market in order to encourage cross border investment* (Study Requested by the FISC Subcommittee, European Union 2022), 35.
[26] European Parliament, *Overview on the tax compliance costs faced by European enterprises – with a focus on SMEs* (Study Analysis requested by the FISC Subcommittee, European Union 2023), 9.
[27] European Commission, 'Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – SME Relief Package' COM (2023) 535 final, 3.
[28] European Commission, 'Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' COM (2023) 528 final, 1.
[29] European Commission, *Tax compliance costs for SMEs: An update and a complement Final Report* (Publications Office of the European Union 2022), 8.
[30] ibid 27.
[31] ibid 35.

obligations. Compliance with such costs appears to be highest for stand-alone companies and companies that have permanent establishments in states other than the state of the head office. As a result, this indicates that the compliance costs of tax obligations are higher for those SMEs operating in states other than the state in which they are headquartered, especially as the heterogeneity of compliance obligations increases.[32]

Overall, this shows that SMEs have higher compliance costs when meeting tax obligations in cross-border activities. They have to spend almost 2.5 % of their annual turnover, which is a major burden for SMEs and therefore also one of the key challenges for cross-border activities in the European Union. In order to promote such activity, the tax framework in the EU needs to be changed.

2.3 Need for harmonization

As identified in the previous chapters, SMEs suffer from the high administrative burden of complying with tax obligations for cross-border activities within the European Union. Therefore, this represents a crucial challenge for SMEs to carry out such cross-border activities. This is also demonstrated by the following example: "[…] *on average, where a big company spends € 1 per employee to comply with a regulatory duty, a medium-sized enterprise spends around € 4 and a small business up to € 10.*"[33] According to this, large companies bear significantly lower compliance costs than SMEs, and the costs even increase the smaller the company is. There is therefore a need to change or harmonize the requirements for compliance with tax obligations at European level.

In the context of tax harmonization for SMEs, the main focus is on simplifying legislation so that it is clearer and easier to implement and thus does not cause disproportionate costs[34]. Complex regulations on compliance with tax obligations and the associated costs also create legal uncertainty for SMEs with regard to non-transparent systems, which also hinders economic growth[35]. However, the compliance costs of cross-border companies, particularly in terms of payable fines, could be significantly reduced if tax systems were simplified. With such a simplified tax system, the costs of companies could be one third lower than those of companies that

[32] ibid 35/36.
[33] European Commission, 'A 'Relief Package' to give our SMEs a lifeline in troubled waters | Blog of Commissioner Thierry Breton' (2022) <https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_22_5653> accessed 23 July 2024.
[34] ibid.
[35] European Commission, 'Commission Staff Working Document – Impact Assessment Report accompanying the document – Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' SWD (2023) 302 final, 7.

are not subject to a simplified tax system with the same company characteristics. It follows that the compliance costs of complying with tax obligations when operating across borders could discourage SMEs and therefore act as a barrier to economic growth in the EU.[36]

The explanations above show that there is a need for harmonization of tax systems at European level. Not only because of the higher compliance costs for SMEs compared to large companies when complying with tax obligations, but also because of the impediment to economic growth within the EU, it is necessary for the European legislator to take action in order to promote the European economy in the long term.

3. Introduction of the directive

As noted in the previous chapters, SMEs are of crucial importance to the European economy, accounting for 99 % of all businesses in Europe and also acting as a key driver of the green and digital transitions in Europe[37]. However, SMEs suffer from the compliance costs of tax obligations when operating cross-border, which often discourages them from operating cross-border within the EU. In order to address this problem, in particular to promote the growth of the European economy, the European Commission adopted a proposal on 12 September 2023 which allows the taxation of permanent establishments of SMEs operating cross-border only by the tax administration of the head office[38]. The following chapter will therefore provide an initial introduction to the proposed directive.

3.1 General overview

This chapter will begin with an overview of the directive in general and the responsibilities of the European Commission and other European institutions.

As SMEs have to deal with the compliance costs of tax obligations in the respective Member State when operating across borders, they are often discouraged from expanding within the EU

[36] ibid 9.
[37] European Commission, 'Championing Europe's SMEs: Commission provides new relief to boost the competitiveness and resilience of SMEs' (2023) <https://ec.europa.eu/commission/presscorner/detail/en/IP_23_4409> accessed 23 July 2024.
[38] European Commission, 'Head Office Tax System for SMEs' (2023) <https://taxation-customs.ec.europa.eu/taxation/corporate-taxation/head-office-tax-system-smes_en> accessed 23 July 2024.

due to the complexity of such regulations, as noted above[39]. The European Commission therefore adopted a proposal for a directive on 12 September 2023 as part of an SME relief package to relieve the burden on SMEs in such cross-border activities[40]. For this purpose, the directive is primarily intended to significantly simplify the area of direct taxes for SMEs if they operate through a permanent establishment in another Member State. In such a case, the tax base of the PE of the SME in the other Member State is to be calculated according to the rules of the Member State in which the SME has its head office. This is intended to ensure that SMEs become active in other Member States earlier and thus further strengthen the European economy.[41]

The legal basis for this proposal for a directive is Article 115 of the Treaty on the Functioning of the European Union (TFEU), which reads as follows: "*Without prejudice to Article 114, the Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market.*" According to this provision, the Council can issue directives for the harmonization of legal and administrative regulations in a special legislative procedure, provided that these have a direct impact on the functioning of the internal market. In this area, the EU and the Member States share competence.[42] Further, directives are binding, according to Article 288 (3) TFEU, for each Member State to which they are addressed, as to the result to be achieved, but leave to the national authorities the choice of form and methods. They include corresponding transposition deadlines, which oblige the Member States to transpose the directives into national law in accordance with Article 4 (3) of the Treaty on European Union (TEU)[43]. With the expiry of the transposition period, they also have direct effect[44].

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[39] European Commission, 'Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – SME Relief Package' COM (2023) 535 final, 4.

[40] European Commission, 'Head Office Tax System for SMEs' (2023) <https://taxation-customs.ec.europa.eu/taxation/corporate-taxation/head-office-tax-system-smes_en> accessed 23 July 2024.

[41] European Commission, 'Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – SME Relief Package' COM (2023) 535 final, 4.

[42] European Commission, 'Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' COM (2023) 528 final, 3.

[43] *Handbuch des EU-Wirtschaftsrechts* (Release No. 60, February 2024), B. II. para 42.

[44] ibid B. II. para 45.

3.1.1 Competence allocation between the EU and Member States

It must first be clarified how competences are generally divided between the EU and the Member States. In principle, the main provisions on the division of competences can be found in the TFEU, whereby the division of competences is also decided jointly between the EU and the individual Member States and set out in the treaties[45].

The competences of the EU can be divided into three areas, namely exclusive, shared and supporting competences, although the list of competences in Article 3 to Article 6 TFEU is not exhaustive[46]. In the area of exclusive competence, only the Union may legislate and adopt binding legal acts in accordance with Article 2 (1) TFEU. In this context, Article 3 TFEU defines the respective areas for which exclusive competence applies, such as the customs union, the establishment of competition rules necessary for the functioning of the internal market, monetary policy, the conservation of marine biological resources under the common fisheries policy and the common commercial policy, in accordance with paragraph 1. In the area of shared competence, the EU shares competence with the Member States in accordance with Article 4 (1) TFEU, unless exclusive competence applies in accordance with Articles 3 and 6 TFEU and the Union has been conferred corresponding competence in the treaties. The Union has shared competence in areas such as the internal market, social policy, economic, social and territorial cohesion, agriculture and fisheries, the environment, consumer protection, transport, trans-European networks, energy, the area of freedom, security and justice, and common safety concerns in the field of public health (cf. Article 4 (2) TFEU). In the case of exclusive competence, only the Union may legislate and adopt binding legal acts in accordance with Article 2 (1) TFEU, therefore the Member States may only act in such a case if they are authorized to do so by the Union or to implement legal acts of the Union, whereas in the case of shared competence, both the EU and the Member States may legislate and adopt binding legal acts in accordance with Article 2 (2) TFEU. In addition, according to Article 5 TFEU, the EU has a coordinating competence in the area of economic policy, employment policy and social policy of the Member States, and according to Article 6 TFEU, a supporting, coordinating or supplementing competence in the area of the protection and improvement of human health, industry, culture, tourism, education and vocational training, youth and sport, civil protection and administrative cooperation.

[45] *Oesterreichische Nationalbank*, 'Kompetenzverteilung in der EU' <www.oenb.at/Ueber-Uns/Aufgaben/die-oenb-im-eurosystem/fakten-zur-eu/kompetenzverteilung-in-der-eu.html> accessed 23 July 2024.

[46] Andreas Haratsch and Christian Koenig and Matthias Pechstein, *Europarecht* (13th edn, Mohr Siebeck 2023), para 144.

3.1.2 Competence in tax regulation

However, it is questionable whether and to what extent the European Union has competence in the area of taxation. The EU Treaty itself does not contain any specific provisions on competence in the area of direct taxation. Accordingly, Article 115 TFEU serves usually as the basis for regulating taxation.[47] This is because Article 115 TFEU refers to the adoption of such directives for the harmonization of national provisions that have a direct effect on the functioning of the internal market[48]. In the area of taxation, this is the case for SMEs operating across borders, as was stated in the previous chapters.

According to Article 115 TFEU, the Council may, in a special legislative procedure, issue directives for the harmonization of laws, regulations and administrative provisions, insofar as these have a direct effect on the functioning of the internal market, whereby unanimity and consultation are required. In the area of direct taxation within the framework of Article 115 TFEU, the Union shares competence with the Member States[49]. In the case of a competence that does not fall within the exclusive competence of the EU, the principle of subsidiarity, which can be found in Article 5 (3) TEU, must also be taken into account[50]. According to this principle, the Union only takes action in areas outside its exclusive competence "[…] *if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.*"[51] The principle of subsidiarity in Article 5 (3) TEU is accompanied by the principle of proportionality in Article 5 (4) TEU, which reads as follows: "*Under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties.*" This means, in particular, that a Union measure must be appropriate and necessary to achieve the objective

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[47] European Parliament, 'Direct taxation: Personal and company taxation' (Fact Sheets on the European Union, 2024) <www.europarl.europa.eu/factsheets/en/sheet/80/direkte-besteuerung-personen-und-unternehmensbesteuerung> accessed 23 July 2024.

[48] European Commission, 'Commission Staff Working Document – Subsidiarity Grid accompanying the documents – Proposal for a Council Directive on Business in Europe: Framework for Income Taxation; Proposal for a Council Directive on establishing a Head Office Tax system for micro, small and medium sized enterprises and amending Directive 2011/16/EU; and Proposal for a Council Directive on Transfer Pricing' SWD (2023) 301 final, 1.

[49] European Commission, 'Commission Staff Working Document – Impact Assessment Report accompanying the document – Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' SWD (2023) 302 final, 10.

[50] Andreas Haratsch and Christian Koenig and Matthias Pechstein, *Europarecht* (13th edn, Mohr Siebeck 2023), para 160.

[51] Consolidated Version of the Treaty on European Union, C 326/13, art 5.

pursued in order to comply with the principle of proportionality[52]. The extent to which the examination of these principles affects the planned directive on the introduction of a head office tax system is examined in more detail below.

3.1.2.1 Principle of subsidiarity

It is questionable to what extent the assessment of the Union's measure is in accordance with the principle of subsidiarity under Article 5 (3) TEU.

As already mentioned in chapter 2, SMEs suffer from the current tax framework in the EU. Due to the large number of regulations, a total of 27 different corporate systems, SMEs often find themselves hindered from operating across borders in the internal market. The reason for this is that SMEs are faced with high compliance costs when complying with their tax obligations due to cross-border activities, which are caused by having to adapt to the tax system of the respective member state. In addition, these different tax systems within the EU can lead to double (non-)taxation. In view of the fact that these problems are due to the different tax systems of the individual Member States, individual national measures do not appear to be effective enough. Therefore, an EU-wide initiative to simplify tax systems for SMEs is the appropriate legal instrument to make cross-border activity more accessible to them. In order to simplify the tax rules for cross-border activities for SMEs, it is necessary to base the assessment of the tax obligations of permanent establishments of SMEs on the same rules that apply to the head office in the home Member State. Such a system within the framework of a directive would comply with the subsidiarity principle in Article 5 (3) TEU as it would not be possible to achieve the objective through national measures of the respective Member States.[53]

3.1.2.2 Principle of proportionality

In addition, the measure of the European Union must be examined with regard to the principle of proportionality in Article 5 (4) TEU.

The planned directive on the introduction of a head office tax system particularly affects the tax base in certain situations whereby the tax regulations of the Member States are not affected.

[52] Andreas Haratsch and Christian Koenig and Matthias Pechstein, *Europarecht* (13th edn, Mohr Siebeck 2023), para 172.
[53] European Commission, 'Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' COM (2023) 528 final, 3.

This is because the proposal for the directive does not provide for the harmonization of corporate tax systems. Instead, the simplification of tax regulations is intended to ensure that SMEs can use the regulations of the Member State in which their head office is located. This will ensure that the Member States mutually recognize and accept the tax systems of the other states within the EU. Such a measure is therefore necessary as it does not go beyond what is required to achieve the planned objective of strengthening the cross-border activities of SMEs. Thus, the proposed directive would also comply with the principle of proportionality in Article 5 (4) TEU.[54]

3.1.3 Interim findings

From this first general overview, it can be stated that the European Commission's proposal for a directive on a head office tax system aims to simplify compliance with tax obligations for SMEs. This is done on the basis of Article 115 TFEU, which allows the Council to adopt directives for the approximation of laws, regulations and administrative provisions in a special legislative procedure, as long as they have a direct effect on the functioning of the internal market, whereby unanimity and consultation are required. In particular, the measure also complies with the principle of subsidiarity in Article 5 (3) TEU and the principle of proportionality in Article 5 (4) TEU, which must always be used for examination if the competence in question is outside the exclusive competence of the EU.

Furthermore, it remains to be clarified in more detail below which exact factors led the European Commission to adopt this proposal, particularly with regard to the development of the circumstances.

3.2 Motivating factors for the European Commission to propose the directive

3.2.1 Development of motivating factors

The previous chapters have already shown the great importance of SMEs for the economy of the European Union. In 2020, the European Commission therefore defined an SME strategy for a sustainable and digital Europe. With this strategy, the Commission wanted to pursue three fundamental objectives: building capacity and supporting the transition to sustainability and digitalization, reducing regulatory barriers and improving market access and improving access

[54] ibid 4.

to finance. The focus was particularly on strengthening Europe's economy and making the EU an attractive location for SMEs so that the single market can grow and expand.[55]

Shortly after the publication of the SME Strategy for a Sustainable and Digital Europe on 10 March 2020, the World Health Organization declared COVID-19 a pandemic. As a result, the European Commission published an update of its SME strategy on 5 May 2021. It clearly showed that the lockdowns associated with the pandemic have hit SMEs hard.[56] The aim of the publication was to take account of the crisis caused by the pandemic and the situation it has created for SMEs, although there were no formal updates to the SME strategy[57]. On 5 May 2021, the European Commission also published the Annual Single Market Report 2021 together with the update of the SME strategy. The report once again clearly showed how hard the pandemic has hit the global economy and SMEs in the EU in particular. Among other things, over 60 % of SMEs in the EU recorded a drop in turnover.[58] It seemed unlikely that SMEs would reach their level of value added from 2019 by the end of 2021[59].

In its resolution of 16 December 2020, the European Parliament welcomed the Commission's SME strategy and called on the Commission to set corresponding binding objectives for the EU for better regulation and simplification of administrative procedures by the end of June 2021[60]. The Commission should also update its SME strategy with regard to the COVID-19 pandemic[61].

On 20 June 2022, the European Commission then published its Annual Report on European SMEs 2020/2021, which also highlighted the importance of SMEs for the European economy

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[55] European Commission, 'Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – An SME Strategy for a sustainable and digital Europe' COM (2020) 103 final, 1/2.
[56] European Commission, 'Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – Updating the 2020 New Industrial Strategy: Building a stronger Single Market for Europe's recovery' COM (2021) 350 final, 1.
[57] European Parliament, 'Small and medium-sized enterprises (SMEs) strategy – In 'A Europe Fit for the Digital Age' ' (2024) <www.europarl.europa.eu/legislative-train/theme-a-europe-fit-for-the-digital-age/file-sme-strategy> accessed 23 July 2024.
[58] European Commission, 'Commission Staff Working Document – Annual Single Market Report 2021 accompanying the – Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – Updating the 2020 New Industrial Strategy: Building a stronger Single Market for Europe's recovery' SWD (2021) 351 final, 7.
[59] European Parliament, 'Small and medium-sized enterprises (SMEs) strategy – In 'A Europe Fit for the Digital Age' ' (2024) <www.europarl.europa.eu/legislative-train/theme-a-europe-fit-for-the-digital-age/file-sme-strategy> accessed 23 July 2024.
[60] European Parliament, 'A new strategy for European SMEs – European Parliament resolution of 16 December 2020 on a new strategy for European SMEs (2020/2131(INI))' (P9_TA(2020)0359), para 1ff.
[61] European Parliament, 'Small and medium-sized enterprises (SMEs) strategy – In 'A Europe Fit for the Digital Age' ' (2024) <www.europarl.europa.eu/legislative-train/theme-a-europe-fit-for-the-digital-age/file-sme-strategy> accessed 23 July 2024.

and the difficulties they have faced in recent years with regard to the pandemic, but also with regard to Russia's war of aggression against Ukraine.[62]

In addition to the adoption of the proposal for a head office tax system on 12 September 2023, the European Commission appointed an SME Envoy on 31 January 2024[63], although he did not start as planned on 16 April 2024, so the resumption of the selection procedure for the role was suspended until after the European elections[64].

Motivated partly by the SME strategy and in view of the challenges faced by SMEs in recent years, the European Commission adopted a proposal on 12 September 2023 for a head office tax system so that SMEs can only work with their head office tax administration when operating cross-border through a permanent establishment[65]. However, it remains to be seen what exact role the Commission will play in the further process regarding the directive.

3.2.2 Procedural process

In the present context, the proposal for a directive on a head office tax system falls under Article 115 TFEU and is subject to a special legislative procedure under Article 289 (2) TFEU[66], which reads as follows: "*2. In the specific cases provided for by the Treaties, the adoption of a regulation, directive or decision by the European Parliament with the participation of the Council, or by the latter with the participation of the European Parliament, shall constitute a special legislative procedure.*" Accordingly, in specific cases provided for in the Treaties, the Council is the sole legislator, while the Parliament either gives its consent to the Commission's proposal or is consulted on it[67]. The Council thus acts as the sole legislator, with Parliament's role being limited to consent or consultation[68]. One of these specific cases provided for in the Treaties is set out in Article 115 TFEU. The Council may "[…] *unanimously in accordance*

[62] European Commission, *Annual Report on European SMEs 2021/2022 – SMEs and environmental sustainability – Background document* (Publications Office of the European Union 2022), 10ff.
[63] European Commission, 'The European Commission appoints an EU SME Envoy' (2024) <https://single-market-economy.ec.europa.eu/news/european-commission-appoints-eu-sme-envoy-2024-01-31_en> accessed 23 July 2024.
[64] European Commission, 'Statement from the Commission Chief Spokesperson following Markus Pieper's announcement renouncing the post of SME envoy' (2024) <https://ec.europa.eu/commission/presscorner/detail/en/statement_24_2061> accessed 23 July 2024.
[65] European Commission, 'Head Office Tax System for SMEs' (2023) <https://taxation-customs.ec.europa.eu/taxation/corporate-taxation/head-office-tax-system-smes_en> accessed 23 July 2024.
[66] European Commission, 'Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' COM (2023) 528 final, 3.
[67] EUR-Lex, 'Special legislative procedure' <https://eur-lex.europa.eu/EN/legal-content/glossary/special-legislative-procedure.html#:~:text=The%20special%20legislative%20procedure%20means,the%20majority%20of%20EU%20legislation).> accessed 23 July 2024.
[68] EUR-Lex, 'Legislative procedures' (2017) <https://eur-lex.europa.eu/EN/legal-content/summary/legislative-procedures.html> accessed 23 July 2024.

with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market.”[69] Thus, the present proposal is subject to a consultation procedure, as the European Parliament must be consulted in accordance with the provisions of Article 115 TFEU, but is not required to give its consent. In such a procedure, the Parliament can approve, reject or propose amendments to the Commission’s legislative proposal, whereby the Council is not bound by the Parliament’s opinion. Furthermore, following the case law of the European Court of Justice, the Council can only adopt a legislative proposal once the Parliament has given its opinion.[70] In addition to the consultation of the Parliament under Article 115 TFEU, the consultation of the Economic and Social Committee is also required.

3.2.3 The European Commission’s role

As part of this process, the European Commission has the so-called monopoly of initiative in accordance with Article 17 (2) TEU[71]. According to Article 17 (2) TEU, a legislative act of the Union may only be adopted if the Commission has made a proposal in advance. On 12 September 2023, the European Commission adopted a proposal for a head office tax system[72], meaning that it is now up to the further special legislative procedure to decide whether the proposal for a directive becomes effective. Under the procedure described above in accordance with Article 115 TFEU on 17 January 2024 the European Economic and Social Committee adopted its report on an opinion on the EU Commission’s proposal regarding the introduction of a system for head office taxation of SMEs, in which it welcomed the Commission’s proposal[73]. Also, the European Parliament adopted a resolution on the Commission’s proposal for a directive on HOT on 10 April 2024[74]. In doing so, the Parliament approved the Commission’s proposal in

[69] Consolidated Version of the Treaty on the Functioning of the European Union, C 326/47, art 115.
[70] European Council and Council of the European Union, ‘Special legislative procedure’ (2024) <www.consilium.europa.eu/en/council-eu/decision-making/special-legislative-procedures/> accessed 23 July 2024.
[71] Andreas Haratsch and Christian Koenig and Matthias Pechstein, *Europarecht* (13th edn, Mohr Siebeck 2023), para 268.
[72] European Commission, ‘Head Office Tax System for SMEs’ (2023) <https://taxation-customs.ec.europa.eu/taxation/corporate-taxation/head-office-tax-system-smes_en> accessed 23 July 2024.
[73] European Economic and Social Committee, ‘Opinion – Establishing a Head Office Tax system for SMEs (HOT) – Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU [COM(2023) 528 final - 2023/0320 (CNS)]’ (ECO/632), 1ff.
[74] European Parliament, ‘Establishing a Head Office Tax system for micro, small and medium sized enterprises’ (2024) <https://oeil.secure.europarl.europa.eu/oeil/popups/summary.do?id=1782745&t=e&l=en> accessed 23 July 2024.

an amended version and called on the Commission to amend the proposal accordingly. Moreover, the Parliament calls on the Council to inform it if it intends to deviate from the approved text and to be consulted again if the Council intends to amend the Commission's proposal substantially.[75] The Council is currently still discussing the proposal for a directive on a HOT system[76].

Therefore, it remains to be seen how the Council will decide to determine the role of the European Commission in the further process of the directive, in particular whether the Commission will comply with the Parliament's amendment proposal.

3.3 Objectives and purpose

As part of the chapter on the introduction of the directive for a HOT system, the intended objectives and purpose of the directive will be described in more detail below.

As the European Commission stated in its Impact Assessment Report on its proposal for a directive introducing a HOT system for SMEs as the main objective of the initiative, the directive aims in particular to simplify tax rules for SMEs in the EU by reducing compliance costs. This in turn aims to ensure the functioning of the internal market, as the number of different corporate tax systems in the individual Member States has so far hindered the cross-border activities of SMEs in the EU and also impaired the level playing field. In addition, one of the Commission's general objectives are to promote growth and investment in the EU through its proposal. This is also to be achieved by reducing the tax rules that SMEs have to comply with when operating across borders. In turn, this means that SMEs are already encouraged to operate across borders in their early stages of development, as they still have to comply with the same tax obligations.[77]

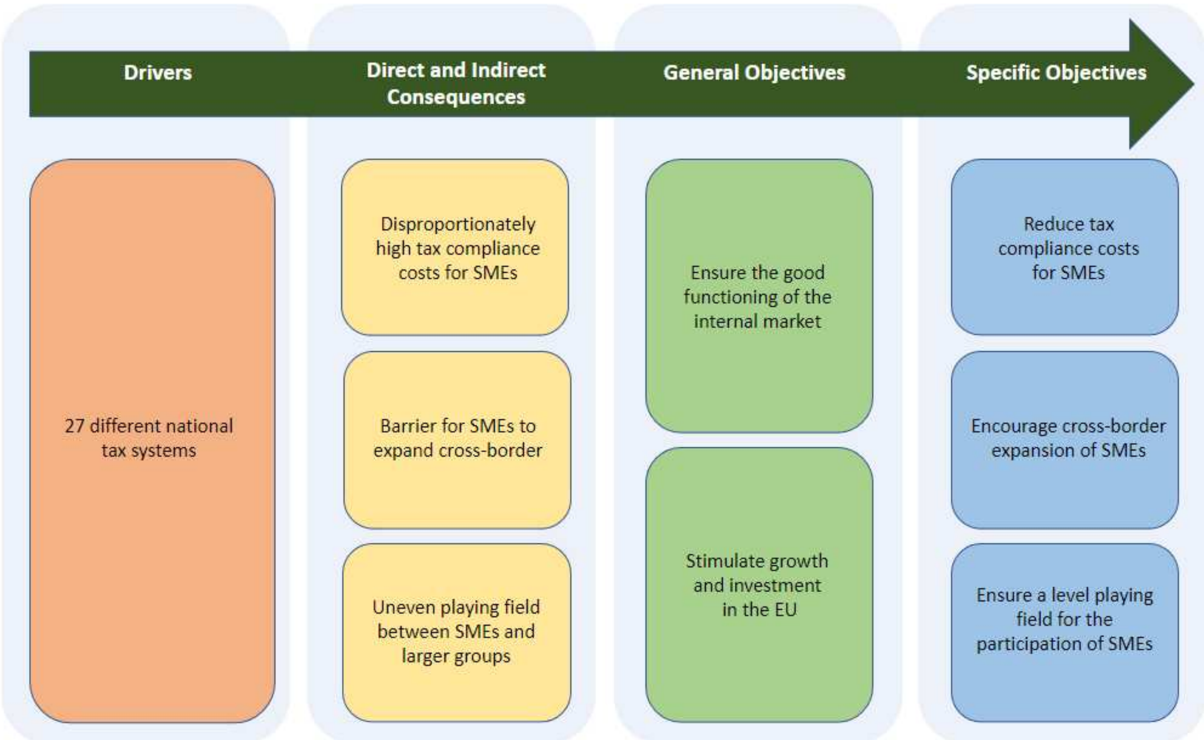
In its Impact Assessment Report, the European Commission also addresses its specific objectives, which are intended to contribute to the achievement of the general objectives. While the general objectives are also the subject of other EU initiatives, the specific objectives are tailored to SMEs and specifically to the proposal for a directive on the introduction of a HOT system

[75] European Parliament, 'European Parliament legislative resolution of 10 April 2024 on the proposal for a Council directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU (COM(2023)0528 – C9-0340/2023 – 2023/0320(CNS))' (P9_TA(2024)0218).
[76] European Parliament, 'Head Office Tax System for SMEs (HOT) – In 'An Economy that Works for People' ' (2024) <www.europarl.europa.eu/legislative-train/theme-an-economy-that-works-for-people/file-hot-head-office-tax-system-for-smes> accessed 23 July 2024.
[77] European Commission, 'Commission Staff Working Document – Impact Assessment Report accompanying the document – Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' SWD (2023) 302 final, 12/13.

for SMEs. One of the main objectives is to reduce compliance costs for SMEs in cross-border activities, which in turn could be achieved by simplifying tax rules, as fewer resources would have to be spent on compliance. In addition, the aim is also to promote the expansion of SMEs into other Member States, particularly in their initial phase, by ensuring that SMEs are not faced with an increase in compliance costs for their tax obligations. Furthermore, according to the Commission, the initiative aims to create a level playing field for SMEs participating in the internal market. Promoting growth should also strengthen their competitiveness and resilience and thus the competitiveness of the EU as a whole in global competition.[78]

The European Commission aims to achieve these intended objectives and purposes through its proposal for a directive on the introduction of a HOT system for SMEs. To summarize, the following figure once again illustrates the challenges that arise in cross-border activities of SMEs and their consequences, as well as the objectives and purpose for eliminating the challenges, which in turn are to be addressed by the Commission's proposal. The specific structure of the directive will be described in more detail in the following chapter.

Figure 2 – Intervention Logic[79]



[78] ibid 13.
[79] ibid 12.

4. The approach of the directive

The fourth chapter will take a closer look at the approach of the European Commission's directive on the introduction of a HOT system for SMEs, in particular by describing the concept and taking a closer look at the directive. Therefore, a comprehensive overview of the structure of the directive and its individual sections and subsections will be provided in order to analyze the extent to which these provisions address the tax challenges for SMEs as identified above. This will be followed by a substantive examination of the provisions and mechanisms of the proposed directive and an assessment of the potential impact of the directive on the taxation and performance of SMEs.

4.1 Description of the approach

4.1.1 Structure of the directive

But first to the structure and organization of the directive on the introduction of a HOT system for SMEs in general. The directive is divided into the following three chapters: (1.) the general provisions, (2.) the head office-based taxation, and (3.) the final provisions. The proposed directive of the Commission consists of a total of 22 articles. It is also accompanied by 18 recitals.[80]

The first chapter "General Provisions" of the directive includes the first three articles, whereby Article 1 describes the subject matter of the directive, namely the definition of the rules for calculating the taxable income of permanent establishments of SMEs, insofar as they meet the criteria of Article 2 (1). While Article 2 then defines the scope of application, which is described in more detail below, Article 3 defines key terms for the directive, such as "permanent establishment" or "head office".[81] However, it is initially questionable when exactly the scope of application of the directive is opened.

4.1.2 Scope of application

It remains to be clarified when the directive applies exactly, meaning when the scope of application for companies is opened.

[80] European Commission, 'Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' COM (2023) 528 final, 9ff.
[81] ibid 12ff.

According to Article 2 (1), SMEs must fulfill the criteria contained in the paragraph in order to fall within the scope of the directive. To do so, they must first be established in accordance with Article 2 (1) (a) under the law of a Member State and comply with one of the legal forms listed in Annexes I and II.[82] According to Annexes I and II, under German law for example, these can be legal entities that are subject directly to a tax on profits, or to any other tax with similar characteristics as the "*Aktiengesellschaft*", "*Kommanditgesellschaft auf Aktien*", "*Gesellschaft mit beschränkter Haftung*", "*Versicherungsverein auf Gegenseitigkeit*", "*Erwerbs- und Wirtschaftsgenossenschaft*" or "*Betrieb gewerblicher Art von juristischen Personen des öffentlichen Rechts*" and other companies established under German law which are subject to German corporation tax, or companies that are subject to a tax on profits at the level of the owners, or to any other tax with similar characteristics as the "*offene Handelsgesellschaft*" or "*Kommanditgesellschaft*"[83]. If this first requirement is met, they must also be resident for tax purposes in a Member State in accordance with its tax law, including its bilateral agreements for the avoidance of double taxation (cf. Article 2 (1) (b)). Furthermore, Article 2 (1) (c) of the directive refers again to the Annex in that SMEs must be subject, directly or at the level of their owners, to a tax on profits listed in Annexes III and IV or another tax with similar characteristics.[84] In the example of Germany, this is the corporation tax and, in the case of the companies listed in Annex II, the income tax[85]. Moreover, SMEs must be considered micro-enterprises or small and medium-sized enterprises according to Article 2 (1) (d) within the meaning of Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings[86]. Those requirements are similar to the general definition of SMEs, as explained in subchapter 1.1, in that micro-enterprises may not employ more than ten people, may not exceed a balance sheet total of € 350,000 and net sales of € 700,000; small companies may not employ more than 50 people and may not exceed a balance sheet total of € 4 million and net sales of € 8 million; and medium-sized companies may not employ more than 250 people and may not exceed a balance sheet total of € 20 million and net sales of € 40 million. Two of the three size criteria may not be exceeded on the balance sheet

[82] ibid 12.
[83] European Commission, 'Annexes to the Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' COM (2023) 528 final, 1ff.
[84] European Commission, 'Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' COM (2023) 528 final, 12/13.
[85] European Commission, 'Annexes to the Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' COM (2023) 528 final, 4/5.
[86] 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/EEC, L 182/19.

date.[87] In addition, Article 2 (1) (e) requires SMEs to operate in another Member State exclusively through one or more permanent establishments. The definition of a permanent establishment within the meaning of the directive is set out in Article 3 (1), according to which a "permanent establishment" is "[…] *a fixed place of business situated in another Member State, as defined under the relevant bilateral convention on the avoidance of double taxation or, in absence thereof, in national law;*"[88]. As a final condition, Article 2 (1) (f) states that SMEs must not be part of a consolidated group for accounting purposes in accordance with Directive 2013/34/EU and must not be a separate undertaking that is an associated undertaking within the meaning of Article 2 (13) of Directive 2013/34/EU or an affiliated undertaking within the meaning of Article 3 (3) of Commission Recommendation 2003/361/EC. More specifically, it should be mentioned that, according to Article 2 (3), the directive is not intended to affect the tax rate to be applied by the respective Member State of a permanent establishment.[89]

Once a company fulfills the relevant criteria of Article 2 (1), the scope of the directive is open, so that the provisions contained therein would be applicable to the respective SME.

4.1.3 Head Office Taxation

However, it remains questionable to what extent the directive has regulated the head office taxation of SMEs in the case of cross-border activities in detail. The relevant provisions can be found in chapter II "Head Office Taxation" of the directive.

At the beginning of the second chapter, Article 4 sets out the conditions for making use of the head office tax rules. According to it, the application is possible if the conditions set out in paragraph 1 are met. Under these conditions, the joint turnover of the permanent establishments of the head office in the last two fiscal years must not exceed twice the turnover achieved by the head office. In addition, the head office must have been resident for tax purposes in the same Member State for the last two financial years. Also, the head office must have met the conditions set out in Article 2 (1) (d) of the directive in the last two fiscal years, meaning it must qualify as a micro, small or medium-sized enterprise within the meaning of Directive 2013/34/EU. If the head office chooses to apply the HOT rules, it should apply these rules to

[87] ibid art 3.
[88] European Commission, 'Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' COM (2023) 528 final, 13.
[89] ibid 13.

all its permanent establishments in other Member States in accordance with paragraph 2, even if a new permanent establishment is set up in another Member State.[90]

Moreover, Article 5 of the directive regulates the exclusion of the HOT system, which is the case if the head office generates income from shipping activities and this income is subject to a tonnage tax regime in the Member State of the head office, provided at least that the permanent establishment also generates income from shipping activities[91]. Recital 6 of the directive explains this by stating that international shipping is a specific sector of activity and is subject to special tax rules in several Member States, so that the exclusion is intended to avoid additional complications[92].

In addition, the following Articles 6 to 10 of the directive regulate the exercise of the option to apply the head office tax rules as well as the duration and termination and the possibility of renewal and its exclusion. If the option is exercised by the head office, the provisions of the directive are to be applied for a period of five fiscal years (cf. Article 7 (1)). According to paragraph 2, after the expiry of the period, the head office tax rules are no longer applicable unless the head office renews their application in accordance with Article 9 of the directive. However, the head office is excluded from such an renewal if, within the five-year period, the combined turnover of its permanent establishments has exceeded twice the turnover achieved by the head office in any two fiscal years, one or more subsidiaries have been established inside or outside the Union or the SME criterion referred to in Article 2 (1) (d) has not been met for two consecutive fiscal years (cf. Article 10). Article 8 also provides the possibility of early termination of the application of the head office tax rules if the SME in question moves its tax residence out of the Member State of the head office or if the combined turnover of its permanent establishments has exceeded an amount equal to three times the turnover of the head office in the last two fiscal years. Although paragraph 4 provides the possibility of applying the head office tax rules when transferring the tax residence to another Member State, this must be regarded as a new option.[93]

The directive continues with Article 11, which regulates how the tax return is to be submitted in accordance with the head office-based taxation, in particular what information must be included and how the tax assessment and coordination between the authorities are regulated. In particular, the authority filing the return in accordance with paragraph 4 shall issue a head office

[90] ibid 14.
[91] ibid 14.
[92] ibid 10.
[93] ibid 14ff.

tax return and a draft tax assessment notice for the respective permanent establishment, which in turn can be accepted or rejected within two months after transmission to the relevant tax authority of the respective Member State (cf. Article 11 (6)). In the event of rejection, the draft tax assessment is revised by the tax authority of the host Member State in accordance with paragraph 8. The crucial factor in the application of the HOT directive is that, according to Article 11 (2) (b), the tax liability of the SME in relation to its permanent establishment is calculated by applying the national tax rate of the respective Member State of the permanent establishment to the taxable result calculated in accordance with the head office tax rules. This means that the rules of the Member State of the head office should be applied to determine the tax base, while the tax rate of the Member State of the permanent establishment should be applied to the taxable result itself. Furthermore, Article 12 contains the regulation with regard to the collection of the tax due by the respective permanent establishment in the host Member State. In this respect, the head office settles the income tax liability both in respect of its taxable result and in respect of the taxable result of its permanent establishment in the relevant host Member State through the filing authority (cf. Article 12 (1)). In doing so, the filing authority collects the tax corresponding to the tax liability of the individual permanent establishments of the head office in the Union, applies the tax rate of the respective Member State of the permanent establishment and transfers the corresponding amount to the competent authority of that Member State (cf. Article 12 (2)).[94]

The second chapter of the directive ends with Articles 13 and 14. Thereby, Article 13 contains provisions on audits, legal remedies and dispute resolution, while Article 14 specifies the extent to which Directive 2011/16/EU[95] is amended by the directive on the introduction of a HOT system.

4.1.4 Final provisions

Chapter III of the directive contains the “Final Provisions”, which are Articles 15 to 22. This final chapter contains more administrative provisions on the directive and its implementation.

Within the final provisions, there are provisions on the assistance of the Commission by a committee (cf. Article 15) or on the exercise of the delegation of power, i.e. the conditions under

[94] ibid 16ff.

[95] Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EU, L 64/1.

which the Commission is empowered to adopt delegated acts (cf. Article 16) and how the European Parliament must be informed (cf. Article 17). While Article 18 contains provisions on data protection, Article 19 provides that the implementation of the directive shall be reviewed by the Commission five years after the date of its application with regard to its functioning and reported to the European Parliament and the Council by accompanying the report with a proposal to amend the directive, if appropriate (cf. Article 19 (1)). Moreover, Article 20 regulates the implementation of the directive by the Member States from 1 January 2026.[96]

Finally, Article 21 regulates the publication of the directive and that it is addressed to the Member States in accordance with Article 22[97].

4.1.5 Key points of approach

This detailed overview of the directive, particularly with regard to its structure, scope and individual chapters, clearly shows the approach of a head office-based taxation of SMEs. Through this approach, a considerable simplification of the procedure is pursued by "[…] *a one-stop-shop should be put in place, whereby the tax filing, tax assessments and the collection of the tax due by the permanent establishment(s) would be dealt with through a single tax authority ('filing authority'), i.e. the tax authority in the Member State of the head office.*"[98] The reason for this is that there is currently no such common approach in the Union for calculating the tax base for companies[99]. Therefore, the European Commission's proposed directive on the introduction of a HOT system is intended to change this.

4.2 Evaluation of the directive

After this detailed overview of the individual provisions of the directive and a deeper understanding of the approach taken by the European Commission with its proposal, the following chapter will now provide a comprehensive review of the provisions and mechanisms of the proposed directive, in particular also with regard to the proposed amendments of the European Parliament, which it adopted in its report on 10 April 2024[100]. In addition, an initial assessment

[96] European Commission, 'Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' COM (2023) 528 final, 20ff.
[97] ibid 22/23.
[98] ibid 10.
[99] ibid 9.
[100] European Parliament, 'European Parliament legislative resolution of 10 April 2024 on the proposal for a Council directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU (COM(2023)0528 – C9-0340/2023 – 2023/0320(CNS))' (P9_TA(2024)0218).

of the potential impact of the directive on the taxation and business activities of SMEs will be made.

4.2.1 Examination of key provisions

First, however, the key provisions of the proposed directive on the introduction of a HOT system for SMEs with cross-border activities are examined below, in particular with regard to their functioning and how they are intended to support the approach pursued by the Commission with the directive.

With its proposed directive, the European Commission is pursuing the approach of simplifying the tax rules for SMEs with cross-border activities within the Union, the so-called “Head Office Taxation” rules (cf. Article 1). As already stated in the above description of the directive, the rules are limited to the taxation of permanent establishments, without affecting the social security rules applicable in the Member State of the permanent establishment or the existing bilateral agreements to avoid double taxation.[101]

The key provisions for pursuing this approach can be found in Articles 4 to 12 of the second chapter “Head Office Taxation” of the directive. The centralized procedure for the HOT system described above is regulated in detail in these articles. The decisive factor in the centralized procedure is that it allows SMEs to interact with only one tax administration, namely that of the head office, provided that the conditions of Article 2 are met. This applies both to the exercise of the option (cf. Article 6) and its renewal (cf. Article 9) as well as to the filing of the tax return (cf. Article 11) and the collection of the tax due (cf. Article 12). The directive itself refers to the head office as the “filing entity” and its tax administration as the “filing authority”. In the course of the procedure, the head office only has to submit a single tax return to its tax administration (cf. Article 11), which in turn transfers the resulting tax revenue to the respective Member State where a permanent establishment of the SME is located (cf. Article 12). Through this procedure and its approach, the Commission aims to make it easier for SMEs to deal with multiple tax systems and administrations, in particular by taking away the costs associated with complying with tax obligations.[102]

[101] European Commission, ‘Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU’ COM (2023) 528 final, 7.
[102] ibid 8.

The Commission's proposal pursues a first option of opening the scope of application only to SMEs that operate in another Member State through a PE[103]. According to Article 3 of the directive, a "permanent establishment" is "[…] *a fixed place of business situated in another Member State, as defined under the relevant bilateral convention on the avoidance of double taxation or, in absence thereof, in national law;*"[104]. In justifying its decision, the Commission argued that it would be more efficient to limit the scope of application to SMEs that are in the initial phase of their expansion. In particular, it is unlikely that SMEs would set up a separate legal entity under the company law of the other Member States in their initial phase, as this would also involve additional compliance costs.[105]

However, the European Parliament is pursuing a second option, which is explained in more detail below.

4.2.2 Proposed amendments by the European Parliament

As already explained in the previous chapters, the European Parliament must be consulted within the framework of a special legislative procedure in accordance with Art. 115 TFEU before the Council can adopt a directive. The Parliament can approve, reject or propose amendments to the Commission's legislative proposal, while the Council is not bound by this opinion. The European Parliament fulfilled this task on 10 April 2024 and adopted its report in which it approves the Commission's proposal in an amended version and therefore calls on the Commission to amend its proposal accordingly. In addition, the Parliament calls on the Council to inform it if it intends to deviate from the approved text and, in particular, to consult it again if it intends to amend the Commission's proposal substantially.[106] What exactly this amended version of the Parliament looks like and what approach it takes will be clarified below.

It is clear from the beginning in Article 1 of the directive under Amendment 19 that the Parliament, like the Commission, wishes to use the directive to lay down rules for computing the taxable results of permanent establishments of SMEs, but also wants to include subsidiaries of SMEs. This is specified in the 20th Amendment to Article 2 of the directive, which defines the scope of application. There, the Parliament wants Article 2 (1) (e) to be amended as follows: "*(e) they operate in other Member States through one or more permanent establishments and/or*

[103] ibid 5.
[104] ibid 13.
[105] ibid 5.
[106] European Parliament, 'European Parliament legislative resolution of 10 April 2024 on the proposal for a Council directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU (COM(2023)0528 – C9-0340/2023 – 2023/0320(CNS))' (P9_TA(2024)0218).

up to two subsidiaries;"[107]. According to the Parliament's proposed amendment, the scope of the directive should be open to SMEs both if they operate across borders through one or more permanent establishments and if they operate across borders through up to two subsidiaries. Accordingly, in the 23rd Amendment, the Parliament wants to add a definition of "subsidiary" to Article 3, which reads as follows: "*(1a) 'subsidiary' means a subsidiary within the meaning of Article 3 (1), point (b), of Council Directive 2011/96/EU situated in another Member State and controlled by the head office;*"[108]. This extension of the scope of application runs through the entire proposed amendment of the Parliament and thus amends the text at the relevant point to include the application of the head office tax rules to the subsidiaries of SMEs.[109]

In addition, the Parliament wants to make an amendment to Article 4 and thus to the conditions for the use of the head office tax provisions. More specifically, the Parliament raises the threshold for the joint turnover of permanent establishments and subsidiaries (cf. Article 4 (1) (a)). This means that their combined turnover in the last three fiscal years may not exceed three times the turnover achieved by the head office, which is probably also due to the fact that the inclusion of subsidiaries would add a further source of income for SMEs. Furthermore, according to Amendments 31 and 32, the head office would have to be resident for tax purposes in the relevant Member State during the previous fiscal year or at least since the establishment of the head office and also meet the conditions of an SME set out in Article 2 (1) (d) during this period.[110] This would therefore mean a shortening of the period to be considered and thus also a corresponding simplification for companies that wish to opt for the head office rules, as even a shorter period can be decisive for the use of the option. The 37th Amendment of the Parliament, which is intended to regulate as a new paragraph 1a of Article 6 of the directive that SMEs can apply the head office tax rules for the establishment of a first PE or subsidiary in another Member State from the year of establishment without having to notify the filing authority three months before the end of the previous tax year, also supports the aim of further simplifying the use. Besides, the Parliament wants to shorten the deadlines in some parts of the directive, in cases where it is necessary to examine and inform the conditions, such as in Article 6 (2) or (3) subparagraph 1. One of the key changes, however, is the extension of the applicable period under Article 7 (1) from five to seven fiscal years.[111]

[107] ibid amendment 20.
[108] ibid amendment 23.
[109] ibid amendment 1ff.
[110] ibid amendment 30ff.
[111] ibid amendment 37ff.

Other amendments include Article 11 (1), where the Parliament wishes to add a second sentence specifying that the Member State of the head office shall assist SMEs in the preparation of tax returns, in particular with regard to the allocation of taxable results to individual permanent establishments and subsidiaries in other Member States[112]. Moreover, according to its amendments, the European Parliament wants the rules to be established by the Member States on the basis of the directive to apply earlier than in the originally proposed directive, i.e. from 1 January 2025[113].

Thus, unlike the Commission, the Parliament is pursuing a second option, namely to allow SMEs to apply the head office tax rules to both their permanent establishments and their subsidiaries. The principle of calculation, i.e. through the Member State of the head office, remains unchanged. However, in contrast to the first option, the impact may be different, as subsidiaries have their own legal personality, while permanent establishments are part of the legal entity of the head office.[114] How exactly the various options can have different effects will therefore be examined in the following as part of an impact assessment.

4.2.3 Impact assessment on SMEs

The question remains as to how the different options could affect their application, which is examined in the following.

While the European Commission's proposal would open the scope of application to SMEs with permanent establishments in another Member State, the European Parliament's proposed amendment would also apply to SMEs with subsidiaries operating in another Member State. How many SMEs exactly would be affected by the directive therefore depends on the choice of option, but also on the number of companies that would opt for a head office taxation. To this end, the European Commission prepared an Impact Assessment Report to estimate the potential benefits and costs of introducing a HOT system, in particular with regard to direct financial savings in tax compliance costs for companies.[115]

In 2019, the costs incurred by companies in complying with tax regulations and the associated fines amounted to € 54 billion, including the costs of both solely domestic and cross-border

[112] ibid amendment 58.
[113] ibid amendment 87.
[114] European Commission, 'Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' COM (2023) 528 final, 5.
[115] European Commission, 'Commission Staff Working Document – Impact Assessment Report accompanying the document – Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' SWD (2023) 302 final, 17.

companies. In the case of companies operating across borders in particular, both permanent establishments and subsidiaries abroad are included. However, the majority of these companies are not yet active across borders and already have to bear the majority of 89 %, i.e. compliance costs amounting to € 48 billion. The table below shows the figures again, divided into SMEs and large companies. It is intended to show how high the costs for the CIT compliance costs (CC) to be borne by the companies are in billions of euros (bn EUR), but also the total amount divided up among the individual enterprises. The table also distinguishes between companies operating purely domestically and those operating across borders.[116] It also makes it clear once again that SMEs bear a significantly higher proportion of the compliance costs and that this represents a significant challenge to becoming active across borders, which has already been explained in the previous chapters and is also reflected in the table.

Figure 3 – Number of firms, absolute and average CIT compliance costs (CC), cross-tabulated by firm size and cross-border activity, 2019[117]

		Operating cross-country?		
		no	yes	Total
SME	CIT CC (bn EUR)	46.9	5.9	52.8
	.. per enterprise	3,223	3,308	3,232
	Number of enterprises	14,566,027	1,784,673	16,350,700
Larger Enterpr.	CIT CC (bn EUR)	0.8	0.3	1.0
	CIT CC per enterprise	9,929	8,266	9,436
	Number of enterprises	77,939	32,824	110,763
Total	CIT compl. Costs (bn EUR)	47.7	6.2	53.9
	.. per enterprise	3,259	3,398	3,274
	Number of enterprises	14,643,966	1,817,497	16,461,463

A study carried out as part of the impact assessment therefore showed that there is the potential to reduce the compliance costs of cross-border companies by up to 32 % if the tax rules are simplified. Based on Figure 3, this could lead to savings of around € 1.9 billion for SMEs operating across borders, which could also motivate SMEs not yet operating across borders to expand into another Member State. If 10 % of domestic SMEs were motivated to operate cross-border, compliance costs of around € 1.5 billion could be saved, which would amount to total savings of around € 3.4 billion per year. Even if only 5 % of previously domestic companies

[116] ibid 47.
[117] ibid 18.

were to start operating cross-border, the total savings could amount to around € 2.3 billion. With a potential cost reduction of 16 % instead of 32 %, total savings of around €1.3 billion per year would be possible with only 5 %. This means that there would be savings in any case, thus a positive effect in the event of tax simplification. However, it is not easy to assess how this would affect the two options presented above by the European Commission and the European Parliament. The available survey data did not distinguish between the cross-border activities of a PE or a subsidiary of SMEs. Although the potential savings costs are likely to be higher for option 2, i.e. the scope of application for SMEs that operate cross-border through both their permanent establishments and their subsidiaries, the benefits at a company level are not. This is because the relevant subsidiaries could already benefit from their size and therefore bear the costs of complying with tax rules more easily than the permanent establishments of SMEs operating in another Member State.[118]

4.2.4 Evaluation of the options

Furthermore, an evaluation of the two options of the European Commission and the Parliament still needs to be carried out, particularly with regard to the impact assessment described above.

As already outlined previously, the European Parliament would like its proposed amendment to include subsidiaries in particular in the scope of the Commission's proposed directive. Such a second option of the optional head office taxation system for SMEs with cross-border activities through both permanent establishments and subsidiaries was already presented by the EU Commission in its proposal for a Council directive on the introduction of a HOT system for SMEs of 12 September 2023. In the final version of the proposed directive, however, the Commission decided against this second option and in favor of the first option, a head office taxation system for SMEs with cross-border activities through permanent establishments. In a more detailed explanation, the Commission justifies this in particular by stating that this option is both effective in achieving the objectives and purpose of the directive and efficient with regard to the limited scope of application for SMEs that want to operate cross-border within the EU with the help of PEs. The directive's approach of simplifying tax rules through a head office-based tax system would enable SMEs, which are often unable to expand across borders due to high compliance costs, to take advantage of this and expand across borders. Moreover, the Commission assumes that, especially in the initial phase of cross-border activity, SMEs would most likely operate through permanent establishments, as cross-border activity through a separate

[118] ibid 18ff.

legal entity under the company law of another Member State would again be associated with additional compliance costs. This would be against the objective of the directive, so that the first option would be most likely to promote cross-border expansion of SMEs and thus full participation in the internal market.[119]

The EU Commission's view with regard to the preferable implementation of a first option, which includes SMEs in the case of cross-border activities of permanent establishments, is to be followed. Although the second option would expand the scope of possible companies and thus also enable a reduction in compliance costs for more SMEs, the HOT system involves optional provisions, meaning that only those SMEs that benefit from it would use it. This is particularly questionable in the case of subsidiaries that have already been established under the law of the respective Member State, as compliance with the relevant regulations is already required. It also seems more likely that SMEs that are not already active across borders within the EU due to high compliance costs will first operate through permanent establishments in another Member State instead of setting up a subsidiary in accordance with the legal requirements in the relevant Member State. Therefore, those who wish to operate cross-border via a subsidiary or already do so will not be able to derive much benefit from the directive, as the costs of setting up and running such a company would already be incurred.[120] Furthermore, it seems unlikely that a proposal for the establishment of a HOT system, also with regard to subsidiaries, will be accepted by the Council as part of the special legislative procedure. A step towards simplifying tax regulations and reducing the burden on SMEs when fulfilling tax obligations has already been achieved with the limitation to permanent establishments, so that the second option should also be rejected from this point of view.[121]

Consequently, the European Commission's proposed directive is the preferable option with regard to the establishment of a HOT system for SMEs operating cross-border through permanent establishments.

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[119] European Commission, 'Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' COM (2023) 528 final, 5.

[120] European Commission, 'Commission Staff Working Document – Impact Assessment Report accompanying the document – Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' SWD (2023) 302 final, 27ff.

[121] *Deutscher Steuerberaterverband e.V.*, 'One-Stop-Shop der Finanzbehörde für KMU mit Betriebsstätte im Ausland' (2023) <www.dstv.de/artikel-pool/one-stop-shop-der-finanzbehoerde-fuer-kmu-mit-betriebsstaette-im-ausland> accessed 23 July 2024.

5. Challenges in implementing a uniform tax system for SMEs

The following chapter will take a closer look at the challenges involved in implementing a uniform tax system for SMEs. The practical and legal obstacles that may arise when implementing the directive for a HOT system will be identified, also with regard to critical points. In addition, a look will be taken at the further economic consequences of tax harmonization.

5.1 Practical challenges

First, the question arises which practical challenges may arise in the enforcement or subsequent implementation of the directive.

5.1.1 Distribution of profit shares

The European Commission's proposal for a directive introducing a head office tax system for SMEs operating cross-border in another Member State through a PE would allow SMEs to calculate their taxable result for all their activities using only the tax rules of the Member State where their head office is located, so that only one tax return has to be filed to the tax administration of the Member State of the head office. The relevant tax administration would in turn submit the tax return to the Member State in which the SME operates through its PE. The Member State of the head office would then apply the tax rate of the other Member States to the profits of the SME's permanent establishment and transfer the corresponding tax revenue there.[122]

Despite these provisions of the directive, it is still questionable what proportion of profits is to be allocated to the tax authority of the head office and how much goes to the Member State of the PE. In the absence of a corresponding regulation, the double taxation agreements (DTAs) between the states must be applied.[123] If the OECD Model Tax Convention 2017 is used as part of a bilateral DTA, which is intended to serve as a basic document for the avoidance of double taxation of income and capital for the negotiation, interpretation, and application of tax treaties[124], Article 7 of the OECD Model Tax Convention must be taken into account. According

[122] European Commission, 'Head Office Tax System for SMEs' (2023) <https://taxation-customs.ec.europa.eu/taxation/corporate-taxation/head-office-tax-system-smes_en> accessed 23 July 2024.
[123] Stefan Bendlinger, 'Einheitlicher Standard der Betriebsstätten-Ergebnisermittlung für KMU in der Europäischen Union' (2023) SWI 2023 <www.icon.at/fileadmin/media/News_Publikationen/Publikationen/Einheitlicher_Standard_der_Betriebsstaetten-Ergebnisermittlung_fuer_KMU_in_der_EU_Bendlinger_Stefan_swi-2023-10_0514-0525.pdf> accessed 23 July 2024, 524.
[124] OECD, 'Tax treaties – The OECD Model Tax Convention on Income and on Capital' <www.oecd.org/en/topics/policy-issues/tax-treaties.html> accessed 23 July 2024.

to Article 7 (1), the profits of a company in a contracting state can only be taxed there if the company does not carry out its business activities through a permanent establishment in the other contracting state, as the profits attributable to the permanent establishment can then be taxed in the other contracting state. According to paragraph 2, the profits attributable to the permanent establishment are those which it could have made if it had carried on the same or similar activities as a separate and independent enterprise under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment.[125] The aim of this provision is therefore to determine the profits to be attributed to a PE in the same way as for an independent company, with the result that profits can also be attributed to a PE if the company as a whole has never generated profits or, conversely, no profits can be attributed to a PE even though the company as a whole has generated profits[126]. However, the extent to which the provision is to be interpreted in detail in practice is one of the most contentious issues in international tax law and also at the top of bilateral mutual agreement procedures, despite corresponding materials such as the Commentary on the OECD Model Tax Convention or the OECD Report on the Attribution of Profits to Permanent Establishments. It remains questionable whether the HOT system can change this.[127]

5.1.2 Information campaign and communication strategy

Besides the distribution of profit shares, the corresponding information and communication with SMEs could also be a practical challenge when enforcing or implementing the directive. As part of the assessment of the impact on SMEs, it was found that the simplification of tax regulations can significantly reduce CIT compliance costs, especially the higher the proportion of SMEs that operate across borders. According to this, between € 1.3 and € 3.4 billion can be saved annually in tax compliance costs, depending on the application. The lower figure would even be achievable if compliance costs could already be reduced by 16 % through the simplification of tax regulations and 5 % of purely domestically active SMEs also decided to operate cross-border in another Member State.[128] However, in order to achieve this goal, SMEs would

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[125] OECD, *Model Tax Convention on Income and on Capital (Full Version) – Volume I and II* (OECD Publishing 2019), M-27.
[126] ibid C(7)-7.
[127] Stefan Bendlinger, 'Einheitlicher Standard der Betriebsstätten-Ergebnisermittlung für KMU in der Europäischen Union' (2023) SWI 2023 <www.icon.at/fileadmin/media/News_Publikationen/Publikationen/Einheitlicher_Standard_der_Betriebsstaetten-Ergebnisermittlung_fuer_KMU_in_der_EU_Bendlinger_Stefan_swi-2023-10_0514-0525.pdf> accessed 23 July 2024, 525.
[128] European Commission, 'Commission Staff Working Document – Executive Summary of the Impact Assessment Report accompanying the document – Proposal for a Council Directive establishing a Head Office Tax system for small and medium-sized enterprises, and amending Directive 2011/16/EU' SWD (2023) 303 final, 2.

need to have the necessary knowledge to even consider the optional regulations. Accordingly, in its proposed amendment to the European Commission's proposed directive, the European Parliament has proposed an amendment to the recitals. This 14th Amendment proposes a new recital 13b, which should read as follows: "*(13b) As the potential reduction of tax compliance costs by SMEs depends directly from their voluntary adoption of the rules set out in this Directive, a thorough and comprehensive Union-wide information campaign targeting SMEs should be envisaged by the Commission. Such information campaign should be integrated in a wider communication strategy on the new tax-related Union law and its impact on Union businesses. All information should be provided in all the official languages of the Member States.*"[129] In doing so, the Parliament wants to ensure that a corresponding detailed and comprehensive Union-wide information campaign for SMEs takes place, which in turn is accompanied by a broad communication strategy on the new tax-related Union law and its impact on EU businesses. The aim is to ensure that SMEs are properly informed in order to make a decision regarding the application of the HOT system. The details of what such an information campaign or communication strategy should look like, however, remain open. One possibility could be to carry out a campaign to inform SMEs through the respective tax consultants. Tax consultants in particular could see the initiative as beneficial, as it would allow them to offer their clients better and more comprehensive advice from a single source. Possible language barriers could also be effectively removed.[130]

Nevertheless, it remains to be seen to what extent this will be effectively implemented in practice, while the effectiveness of the directive depends crucially on its use by SMEs.

5.2 Legal barriers

Further, it remains to be clarified which legal barriers could hinder the implementation of the directive.

As already explained, the European Commission's proposal is based on Article 115 TFEU, according to which the Council, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee,

[129] European Parliament, 'European Parliament legislative resolution of 10 April 2024 on the proposal for a Council directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU (COM(2023)0528 – C9-0340/2023 – 2023/0320(CNS))' (P9_TA(2024)0218), amendment 14.
[130] *Deutscher Steuerberaterverband e.V.*, 'One-Stop-Shop der Finanzbehörde für KMU mit Betriebsstätte im Ausland' (2023) <www.dstv.de/artikel-pool/one-stop-shop-der-finanzbehoerde-fuer-kmu-mit-betriebsstaette-im-ausland> accessed 23 July 2024.

may adopt directives for the approximation of such laws, regulations and administrative provisions of the Member States as directly affect the establishment or functioning of the internal market[131]. Following a corresponding consultation, both the European Economic and Social Committee on 17 January 2024[132] and the European Parliament on 10 April 2024[133] adopted their reports accordingly, each supporting the overall proposal of the European Commission, while the Parliament recommended extending the scope of application to companies that operate across borders through up to two subsidiaries in addition to permanent establishments. This is intended to ensure that more companies in particular can benefit from the simplification of tax regulations through the directive for a HOT system. Based on this status, the Council must now vote on the EU Commission's proposal in accordance with Article 115 TFEU. Initial discussions already took place in the Council in June 2024, although it concluded that further in-depth discussions were required before a decision could be made.[134]

5.2.1 Council decision by the Member States

According to Article 115 TFEU, a unanimous decision is required in the Council so that it can adopt the European Commission's proposal on the HOT directive as part of the special legislative procedure. In accordance with Article 16 (2) TEU, the Council consists of one representative of each Member State at ministerial level, who is authorized to act on behalf of the government of the Member State to represent and to exercise the right to vote, so that the interests of the Member States in particular can be represented at Union level.

As unanimity in the Council is required at Union level in tax matters (cf. Article 115 TFEU), even one Member State can delay or even prevent attempts at harmonization[135]. It is therefore crucial for the further development of the HOT directive that every representative of the Member States in the Council approves the proposal in a decision. However, this could be problematic, especially as tax sovereignty in the EU is predominantly the responsibility of the Member States. In the area of indirect taxation, the Union is competent for the purpose of harmonizing

[131] European Commission, 'Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' COM (2023) 528 final, p. 3.
[132] European Economic and Social Committee, 'Opinion – Establishing a Head Office Tax system for SMEs (HOT) – Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU [COM(2023) 528 final - 2023/0320 (CNS)]' (ECO/632).
[133] European Parliament, 'Establishing a Head Office Tax system for micro, small and medium sized enterprises' (2024) <https://oeil.secure.europarl.europa.eu/oeil/popups/summary.do?id=1782745&t=e&l=en> accessed 23 July 2024.
[134] European Parliament, 'Head Office Tax System for SMEs (HOT) – In 'An Economy that Works for People' ' (2024) <www.europarl.europa.eu/legislative-train/theme-an-economy-that-works-for-people/file-hot-head-office-tax-system-for-smes> accessed 23 July 2024.
[135] *Handbuch des EU-Wirtschaftsrechts* (Release No. 60, February 2024), J. para 36.

legislation in accordance with Art. 113 TFEU, but in the area of direct taxation, competence lies with the Member States. Within the framework of Art. 115 TFEU, however, shared competence can be established in order to safeguard Union law.[136] In a first round of discussions, a large number of delegations already expressed serious concerns about various aspects of the HOT directive, such as the administrative or aggressive tax planning challenges that HOT may create for tax authorities, the risks to competitiveness and more general concerns about the preservation of tax sovereignty[137]. As part of the publication of the contributions of some Member States, a decision was also taken by the German *Bundesrat* on 2 February 2024 on the proposal for the HOT directive. In particular, this report states that although the *Bundesrat* also believes that the goal of further simplification for SMEs with regard to cross-border activities and the administrative burden should be supported, it sees this as a national task. While coordination should be considered at EU level, it should not take the form of the HOT directive, as these regulations are too far-reaching and would interfere with the Member States' freedom of action. In particular, the HOT system would lead to a considerable increase in the administrative burden, as cross-border networking of tax authorities would be necessary. Moreover, the *Bundesrat* criticizes that the directive could lead to distortions of competition and consequences contrary to equality to the disadvantage of domestic companies, e.g. if a domestic company were to be taxed differently than a domestic PE of a foreign company. Overall, the German *Bundesrat* does not currently consider the EU Commission's proposal to introduce the HOT directive to be acceptable.[138]

As stated above, one Member State alone could prevent the adoption of the directive. It can be assumed that some Member States are of a similar opinion to the German *Bundesrat*, particularly with regard to the preservation of tax sovereignty. It therefore remains questionable whether the European Commission's proposal to introduce a head office taxation system will stand up to unanimous decision-making in the Council. For now, however, it has to be seen how the Council will ultimately decide.

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[136] ibid J. para 26/27.
[137] European Parliament, 'Head Office Tax System for SMEs (HOT) – In 'An Economy that Works for People' ' (2024) <www.europarl.europa.eu/legislative-train/theme-an-economy-that-works-for-people/file-hot-head-office-tax-system-for-smes> accessed 23 July 2024.
[138] *Bundesrat*, 'Beschluss des Bundesrates – Vorschlag für eine Richtlinie des Rates zur Einführung eines hauptsitzbasierten Steuersystems für Kleinstunternehmen, kleine und mittlere Unternehmen sowie zur Änderung der Richtlinie 2011/16/EU – COM(2023) 528 final – Drucksache: 539/23 und zu 539/23' Drucksache 539/23 (Beschluss) (Grunddrucksachen 539/23, 580/23 und 634/23), 2ff.

5.2.2 Administrative tax planning challenge

The administrative tax planning challenge that HOT may bring for the tax authorities is also viewed critically[139]. In its statement on the proposal for a Council directive on the establishment of a HOT system for SMEs, the German *Bundesrat* also notes that the proposed system of taxation at the head office would lead to a significant increase in the administrative burden, particularly as cross-border networking of tax authorities would be necessary to implement the regulations. In addition, it would be necessary to develop completely new procedures for just a few cases, as well as to train staff accordingly and thus train them for such cases. This will be rejected by the *Bundesrat* in view of the difficult personnel situation.[140]

Along with these highlighted disadvantages, however, the initiative could also have advantages for tax authorities. To begin with, the introduction of HOT tax returns would also reduce the total number of tax returns at EU level, as there would be at least one less filing in another Member State for each HOT tax return. Although the respective other Member State would still have to invest some resources in receiving the HOT tax return and checking the proposed tax assessment for approval, the EU Commission assumes in its Impact Assessment that the initiative will nevertheless release resources in the tax administrations. This is because the current complexity and lack of transparency would also create opportunities for irregularities and fraud, so that companies with permanent establishments could take advantage of this by having their activities controlled by different administrations. Therefore, this risk could be reduced if SMEs only had to deal with one tax authority in one Member State for their entire activity in the EU. Accordingly, the Commission sees the HOT system as an opportunity to facilitate the fight against fraud and to support the tax administration in reducing the tax gap in corporate tax. However, it seems questionable how the differences in the capacity and expertise of tax authorities between Member States could affect the implementation of the directive in detail, also with regard to the additional workload, which in turn depends on the number of SMEs that decide to apply the HOT system.[141]

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139 European Parliament, ‘Head Office Tax System for SMEs (HOT) – In ‘An Economy that Works for People’ ’ (2024) <www.europarl.europa.eu/legislative-train/theme-an-economy-that-works-for-people/file-hot-head-office-tax-system-for-smes> accessed 23 July 2024.

140 *Bundesrat*, ‘Beschluss des Bundesrates – Vorschlag für eine Richtlinie des Rates zur Einführung eines hauptsitzbasierten Steuersystems für Kleinstunternehmen, kleine und mittlere Unternehmen sowie zur Änderung der Richtlinie 2011/16/EU – COM(2023) 528 final – Drucksache: 539/23 und zu 539/23’ Drucksache 539/23 (Beschluss) (Grunddrucksachen 539/23, 580/23 und 634/23), 2/3.

141 European Commission, ‘Commission Staff Working Document – Impact Assessment Report accompanying the document – Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU’ SWD (2023) 302 final, 21/22.

It could thus be problematic in detail to require close cooperation between the individual tax administrations of the Member States for the directive to function. In particular, new functions and systems would need to be integrated at the beginning, such as the task of the tax administration of the head office to forward the tax revenue collected to the Member States of the permanent establishments, and thus also an initial investment on the part of the tax administrations[142]. Therefore, it remains to be seen whether such an implementation would be possible in practice.

5.3 Economic implications

Lastly, it should be looked at how such tax harmonization could affect the competitiveness of SMEs.

In general, the European Commission assumes that the introduction of a system of head office taxation could reduce compliance costs for SMEs when complying with tax obligations for cross-border activities in all areas of the internal market. This could help SMEs to participate fully in the internal market, thereby strengthening cross-border activity and the international competitiveness of companies in the European Union. The fact that the rules for SMEs are optional is not seen as a disadvantage, as this would give SMEs the advantage of choosing the simplest and most cost-efficient solution based on their individual needs.[143]

However, the extent to which the directive aims to prevent possible tax abuse, e.g. by purposefully relocating headquarters to low-tax countries, could be viewed critically. According to the HOT directive, SMEs should be able to renew their decision every five years without limit, meaning that they must also apply the system for a total of five years. If the Member State of the head office changes during this time or if the SME's foreign business activity grows exponentially compared to the business activity in the home Member State, the regulations should no longer be applicable in order to deter potential tax planning practices. In addition, the Member States should remain responsible for audits of permanent establishments in their territories and should also be able to request mandatory joint audits with other Member States.[144] The European Commission accepts that the optional application of the HOT system could lead to distortions of competition in some cases due to different taxation rules, but sees greater overall

[142] ibid 23.
[143] European Commission, 'Commission Staff Working Document – Executive Summary of the Impact Assessment Report accompanying the document – Proposal for a Council Directive establishing a Head Office Tax system for small and medium-sized enterprises, and amending Directive 2011/16/EU' SWD (2023) 303 final, 3.
[144] European Commission, 'Head Office Tax System for SMEs' (2023) <https://taxation-customs.ec.europa.eu/taxation/corporate-taxation/head-office-tax-system-smes_en> accessed 23 July 2024.

benefits in the system for SMEs[145]. Also, it remains doubtful whether such tax planning practices do not already take place without the directive.

Overall, the introduction of a simplification framework through the HOT directive for SMEs operating across borders should therefore have a positive impact on cost and price competitiveness. In particular, compliance costs would be reduced and thus also the costs for the international expansion of SMEs. This initial help for SMEs to grow in the internal market could also enable them to subsequently expand outside the European Union.[146]

6. Conclusion

In a final step and also the last chapter of this thesis, the most significant findings from the examination of the European Commission's proposal for a directive on the introduction of a head office tax system for SMEs and its possible effects will be summarized in the following in order to then take a look at the overall assessment. In particular, a final look will be taken at the extent to which the questions raised at the beginning of the work have been answered.

6.1 Summary of findings

As shown at the beginning of the thesis in chapter 1, SMEs are of great importance to the European economy due to their large number of companies and as the biggest employer in the EU. SMEs have faced many challenges in recent years, such as the Covid-19 pandemic or the Russian war of aggression against Ukraine, which have had a severe economic impact on SMEs. In addition, SMEs found it difficult to participate in the internal market in the EU, in particular due to high compliance costs associated with complying with tax obligations in another Member State. This in turn hindered the competitiveness and growth of the European market in a global comparison. In chapter 2, it thus became clear that, due to the 27 different national tax systems in the EU, harmonization is required in order to make it easier for SMEs to connect to the internal market and thus operate across borders. The European Commission wanted to address this problem by introducing a proposal for a directive on the introduction of a head office-based tax system on 12 September 2023. Within chapter 3, its aim to reduce compliance costs

[145] European Commission, 'Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' COM (2023) 528 final, 8.
[146] European Commission, 'Commission Staff Working Document – Impact Assessment Report accompanying the document – Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU' SWD (2023) 302 final, 53.

for SMEs by simplifying tax obligations and thus encourage them to expand across borders became clear. The detailed description of the directive highlighted in particular the centralized procedure set out in the directive, as outlined in chapter 4, whereby SMEs only have to file a single tax return for themselves and all their permanent establishments operating in another Member State, namely with the tax authority of their head office, if they choose to apply the HOT rules. Besides amendments proposed by the European Parliament, the proposed directive faces a challenge from the Council which must vote unanimously on the proposed directive, which could prove difficult, as shown in chapter 5.

6.2 Overall assessment

By looking at the introduction of the thesis, the following questions were answered: How did the European Commission's directive come about in the first place? What problem does the directive attempt to solve? What does the directive say? What are the challenges in implementing a uniform tax system for SMEs? In an overall assessment of the work, it emerges that SMEs suffer from having to comply with different tax systems in the Union and, in particular, are prevented from using the full potential of the internal market. The proposed directive seeks to address this problem by requiring SMEs to calculate their taxable results for all their activities, including cross-border activities through permanent establishments, using only the tax rules of the Member State of the head office and then applying the tax rate of the Member State of the permanent establishment to the result. This would lead to a saving in compliance costs, even with only a small percentage of application, as shown in subchapter 4.2.3. However, corresponding problems could arise from a lack of information and therefore a lack of application by SMEs, although this could be resolved at tax advisor level. The biggest hurdle is the vote in the Council, which must be unanimous for the proposed directive to be adopted. As the work has shown, this could prove difficult as the Member States do not want to give up their exclusive competence in the area of direct taxation.

With regard to the objective to be achieved, namely the simplification of compliance with tax obligations for SMEs, the European Commission's proposal for a directive appears to be a first step in the right direction. In particular, such head office-based taxation can encourage SMEs to become active across borders at an earlier stage. Moreover, this can lead to a strengthening of the internal market and thus of the European economy. Even if the proposal is not yet able to solve all problems in detail, such as combating tax abuse, it is nevertheless an improvement in the tax framework for SMEs. Overall, the European Commission's proposal for a directive on the introduction of a HOT system is to be welcomed with a view to strengthening a unified internal market.

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Abstract

English

This master's thesis deals with the European Commission's proposal for a directive from 12 September 2023 on the introduction of a system of head office-based taxation for small and medium-sized enterprises (SMEs) that operate or intend to operate cross-border through a permanent establishment in another Member State.

SMEs are of great importance for the European economy, especially as they represent the majority of companies in the Union and also provide two thirds of all jobs in the private sector. Over recent years SMEs have faced some difficult challenges, such as the Covid-19 pandemic and the resulting supply bottlenecks, as well as the Russian war of aggression against Ukraine and the resulting higher energy costs, which have reduced their profitability. So far, SMEs have not been able to reach their pre-pandemic performance level.

In addition, the different national tax systems within the European Union make it difficult for SMEs to gain full access to the internal market. Due to high compliance costs for complying with tax obligations when operating in another Member State, SMEs are often hindered from operating across borders at all.

The European Commission wanted to address this problem with its proposal for a directive. Through an in-depth examination and evaluation of the proposal, this master's thesis aims to identify the potential challenges of introducing a head office tax system for SMEs and how effective such a taxation system would be in terms of compliance costs. In particular, the thesis aims to clarify the extent to which the proposed directive could strengthen the competitiveness of SMEs and therefore the European economy.

German

Diese Masterarbeit befasst sich mit dem Richtlinienvorschlag der Europäischen Kommission vom 12. September 2023 zur Einführung eines Systems zur hauptsitzbasierten Besteuerung von kleinen und mittelständischen Unternehmen (KMU), die grenzüberschreitend über eine Betriebsstätte in einem anderen Mitgliedstaat tätig werden wollen oder bereits tätig sind.

KMU sind von immenser Bedeutung für die Europäische Wirtschaft, insbesondere da sie einen Großteil der Anzahl an Unternehmen in der Union ausmachen und auch zwei Drittel aller Arbeitsplätze in der Privatwirtschaft stellen. In den letzten Jahren sahen sich KMU einigen schwierigen Herausforderungen wie der Covid-19-Pandemie und den daraus resultierenden Versorgungsengpässen sowie dem russischen Angriffskrieg gegen die Ukraine und den daraus resultierenden höheren Energiekosten gestellt, sodass deren Rentabilität verringert wurde. Bisher gelang es KMU nicht, ihr Leistungsniveau von vor der Pandemie zu erreichen.

Zudem fällt es KMU schwer aufgrund der verschiedenen nationalen Steuersysteme innerhalb der Europäischen Union vollen Zugang zum Binnenmarkt zu erhalten. Mit Blick auf die hohen Befolgungskosten bei der Einhaltung steuerlicher Pflichten, die bei einer Tätigkeit in einem anderen Mitgliedstaat entstehen, sehen sich KMU oftmals davon abgehalten, überhaupt grenzüberschreitend tätig zu werden.

Diesem Problem wollte die Europäische Kommission mit ihrem Richtlinienvorschlag Rechnung tragen. Durch eine eingehende Prüfung und Bewertung des Vorschlags soll im Rahmen dieser Masterarbeit herausgearbeitet werden, welche möglichen Herausforderung bei einer Einführung eines Hauptsitzsteuersystems für KMU bestehen könnten und wie effektiv eine solches Besteuerungssystem im Hinblick auf die Befolgungskosten wäre. Insbesondere soll im Rahmen der Arbeit geklärt werden, inwiefern der Richtlinienvorschlag die Wettbewerbsfähigkeit von KMU und somit auch die Europäische Wirtschaft stärken könnte.