

HOT: A head office tax system for small companies

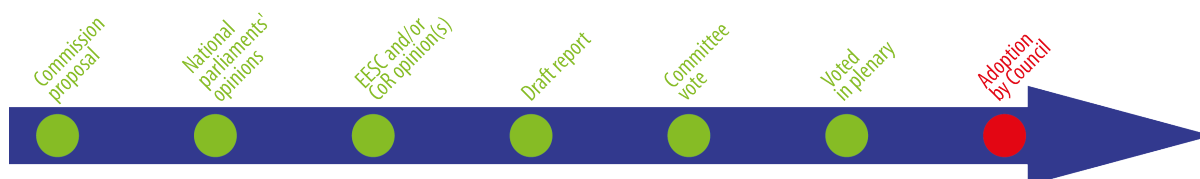
OVERVIEW

When businesses start operating across borders, they are faced with a new and unfamiliar corporate tax system in each EU Member State. As a result, businesses with cross-border activities have to spend time and resources on understanding and complying with complex local corporate tax rules. This represents a significant administrative burden, in particular for small companies.

On 12 September 2023, to lower tax compliance costs, the European Commission tabled a proposal for a Council directive to establish a head office tax system (HOT) for small businesses. Under HOT, micro-enterprises and small and medium-sized enterprises operating exclusively through permanent establishments would be able to continue to apply their national corporate tax rules – i.e. the rules they are already most familiar with – when they expand across borders. They would also be able to file a single tax return in the Member State of their head office, rather than separate tax returns in the different Member States. This would cut compliance costs and remove a significant barrier to the cross-border expansion of small companies in the single market.

The proposal is subject to a special legislative procedure, requiring unanimous support in Council, following consultation of the European Parliament and the European Economic and Social Committee. The European Parliament adopted its (non-binding) resolution in April 2024. Negotiations in Council are still on-going.

HOT – Proposal for a Council directive establishing a head office tax system for micro-, small and medium-sized enterprises		
<i>Committee responsible:</i>	Economic and Monetary Affairs (ECON)	COM(2023)528 12.9.2023
<i>Rapporteur:</i>	Lídia Pereira (EPP, Portugal)	2023/0320(CNS)
<i>Shadow rapporteurs:</i>	Aurore Lalucq (S&D, France) Martin Hlaváček (Renew, Czechia) Claude Gruffat (Greens/EFA, France) Andżelika Anna Możdżanowska (ECR, Poland)	Consultation procedure (CNS) – Parliament adopts a non-binding opinion
<i>Next steps expected:</i>	Adoption by Council	



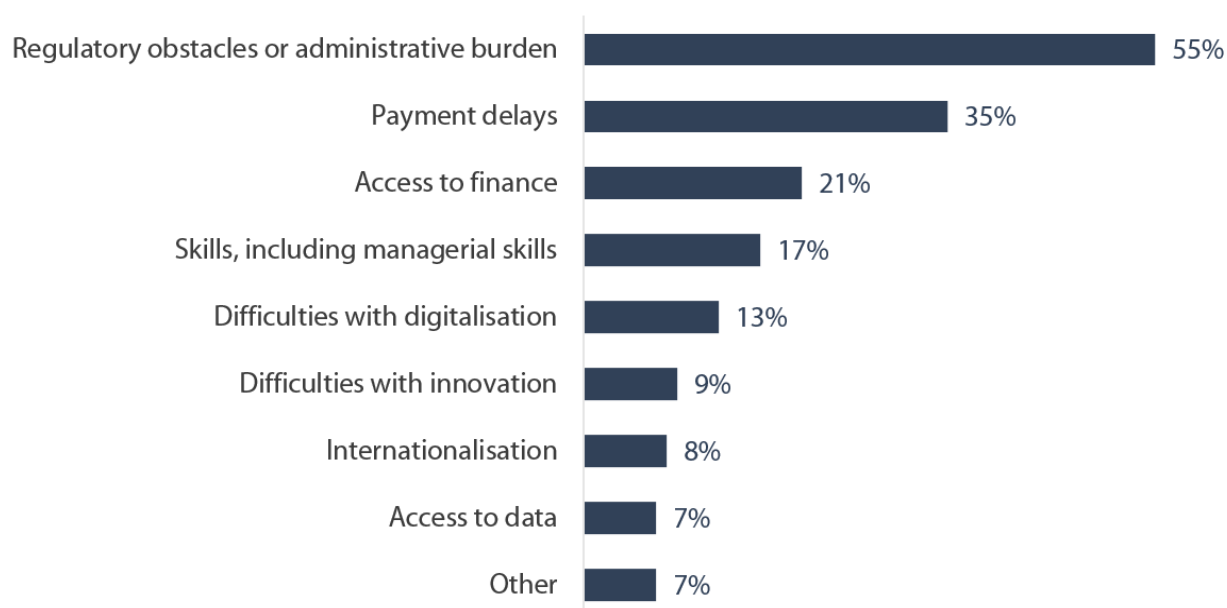
Introduction

In 2022, there were more than [24 million](#) small and medium-sized enterprises (SMEs) active in the EU, representing around two thirds of private sector jobs (85 million people) and 99 % of all businesses in the EU. The backbone of the EU economy, SMEs play a vital role in today's green and digital transition. On 12 September 2023, the European Commission tabled an [SME relief package](#), presenting a series of initiatives to support small businesses across the EU. An accompanying [communication](#) on the package put forward 19 legislative and non-legislative actions the Commission will take to strengthen EU SMEs, with the objective to make things easier for small businesses and improve their access to finance and a skilled workforce.

During her 2023 [state of the Union](#) address, Commission President Ursula von der Leyen highlighted the difficult situation SMEs can find themselves in: 'Small companies do not have the capacity to cope with complex administration. Or they are held back by lengthy processes. This often means they do less with the time they have – and that they miss out on opportunities to grow'.

A recent Eurobarometer survey showed how regulatory obstacles and administrative burdens are the problems most mentioned by SMEs (see Figure 1).

Figure 1 – Key challenges for SMEs in the EU



Data source: [Flash Eurobarometer 486](#) (2020) – SMEs, start-ups, scale-ups and entrepreneurship.

Existing situation

SMEs and corporate taxation

When businesses start operating across borders, they face new and unfamiliar corporate tax systems in each EU Member State. To calculate their taxable income in each Member State, businesses have to **understand and comply with different national rules on depreciation, amortisation, tax deductibility of losses, treatment of interests, dividends, bad debts, fines, etc.** To avoid mistakes (and subsequent hefty fines), businesses may need to take legal and tax advice on compliance with local tax obligations. Along with the complex calculation of the taxable result, businesses need to familiarise themselves and comply with different rules on procedures, tax returns and contact with tax authorities (e.g. deadlines, online portals and language).

This complexity and the related compliance costs discourage (small) businesses from expanding across the single market, to the detriment of EU economic growth and competitiveness. According to a recent [study](#) on tax compliance costs, in 2019 businesses in the EU-27 plus the United Kingdom faced an estimated total of **€204 billion in tax compliance costs** (corporate tax, VAT, energy taxes, property taxes, etc.).¹ This translates to an average tax compliance cost of 1.9 % of business turnover. Estimated tax compliance costs relating to corporate income tax ranged from approximately €2 700 for micro-enterprises to approximately €5 000 for medium-sized enterprises. Worryingly, the authors found that total tax compliance costs had increased, compared with when the team of researchers first looked at such data in [2014](#). A 2023 [study](#) on the same topic, carried out for the European Parliament's Subcommittee on Tax Matters (FISC), acknowledged the difficulties companies face as a result of high tax compliance costs, but also pointed out differences in how Member States were faring in this domain. In particular, the Nordic and Baltic countries were among 'the best performers' in the EU and could be a source of reference when defining best practices, the authors argued.

One-stop shop for VAT

To understand better how HOT simplifies corporate tax obligations for (small) businesses that operate across borders, it is helpful to take into consideration the major steps that have been taken in the field of VAT for EU companies with cross-border activities. A central feature in this respect is the EU **VAT one-stop shop (OSS)**.

To ensure that a business making cross-border supplies to private customers declares and remits the VAT due in the Member State where the goods finally arrive, businesses used to be required to register for VAT in that other Member State. However, registering for VAT abroad can be a lengthy and costly procedure. The registration process itself generally requires the provision and filing of numerous documents (possibly in a language the business registrant does not speak) with the local authorities. The Commission has [estimated](#) this one-off cost at a minimum of €1 200 per Member State in which the business registers. Once registered, the business must start complying with the national VAT laws of that Member State regarding invoicing, reporting, filing and payment. These compliance costs have been estimated at between €2 400 and €8 000 annually.

To remove the need for companies to hold multiple VAT registrations and declare several VAT returns in the different Member States, the EU introduced the [OSS](#) in 2015, an **online portal allowing sellers to declare and pay VAT on all sales across the EU** in one go.² With the OSS, a business can file its VAT return via the OSS portal of its national tax authority, declaring and paying the VAT due on all its EU sales. Afterwards, the national tax authority transfers the VAT revenue collected to the respective Member States. While the scope of this portal was restricted at first to a very limited range of transactions, businesses can today use the OSS to declare and remit VAT on all sales of services and e-commerce goods to private consumers in the EU.³ The launch and broadening of the OSS went together with multilingual [media and awareness](#) campaigns by the European Commission and national tax authorities in order to prepare companies for the forthcoming changes and inform them about the new opportunities and simplifications this voluntary scheme could offer.⁴ By June 2023, some [130 000 companies](#) were already filing their VAT return via the OSS, and the figure is expected to rise in the coming years.⁵ In 2022 alone, more than €17 billion in VAT revenue was collected via the OSS.⁶

In the impact assessment, the European Commission [acknowledged](#) that HOT '**could be seen as a complement**' to the VAT OSS.

Permanent establishments and subsidiaries

When a business decides to start operating abroad, it needs to reflect on the company structure and its tax obligations. An important distinction in this context is that between a permanent establishment (PE) and a subsidiary.

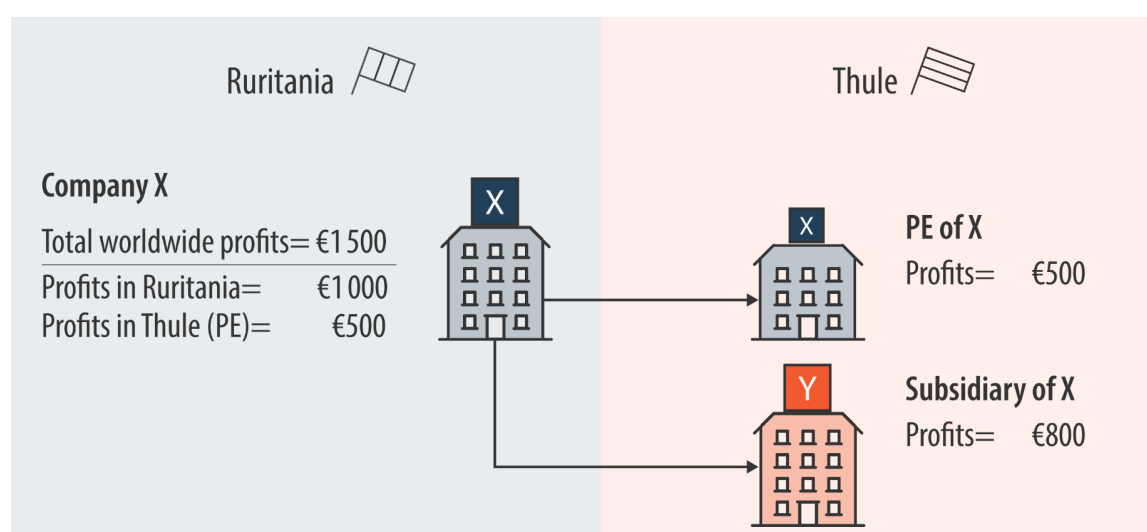
A PE is a crucial international tax law concept.⁷ While national definitions may differ, PEs are usually defined as **'a fixed place of business through which the business of an enterprise is carried on in whole or in part'**. This typically includes a branch, an office, a factory, or a workshop, for instance, but there are also other, less obvious situations, where a PE may exist.

Take for example, a painter resident in country X spends 3 days a week in the large office complex of his main client, resident in country Y, for 2 years. In that case, the presence of the painter in that office's premises where he is performing the most important functions of his business (i.e. painting) could constitute a permanent establishment of that painter in country Y.⁸

The identification of PEs is crucial to **determine taxing rights between countries**. In [bilateral tax agreements](#), the PE concept acts as 'a threshold' to determine whether or not the host country has taxing rights with respect to a foreign business operating in that country. As a general rule, once a foreign business establishes a PE, the host country is allowed to tax the net profits attributable to that PE. The PE nevertheless remains legally dependent on its parent company.

By contrast, a subsidiary is an entity that has its own legal personality, is incorporated under the national company law of the country in which it is located, and as a resident is therefore subject to local company law.

Figure 2 – Example of cross-border tax arrangements for permanent establishments and subsidiaries under a bilateral tax agreement



Company X has total worldwide profits of €1 500 and is tax resident in the fictional country of Ruritania. One third of its profits are generated in a PE in the fictional country of Thule (€500), while the remainder (€1 000) is made in Ruritania. Company X also has a subsidiary in Thule – Company Y – which earns €800 in profits.

Under a traditional bilateral tax agreement:

- Ruritania has the right to tax the worldwide profits of Company X – i.e. those generated by the parent and the PE – €1 500. It cannot tax the profits made by the subsidiary in Thule. To prevent double taxation, Ruritania offers tax relief concerning the €500 profits made by the PE when these are taxed by Thule.
- Thule can tax the subsidiary's profits (€800) and the profits generated by the PE (€500).

Source: EPRS, 2023.

Preparation of the proposal

In July 2020, the Commission tabled a [communication](#) on an action plan for 'fair and simple taxation supporting the recovery strategy', in which it acknowledged that businesses were still struggling with complex tax rules. A [public consultation](#) was launched in the second half of 2022, aimed at companies, non-governmental organisations (NGOs) and business associations.⁹ Generally, all respondents acknowledged that businesses were still facing high tax compliance costs in the EU, in particular those companies engaged in cross-border activities. Several respondents explicitly favoured a 'one stop shop' solution to address this issue, reminiscent of the VATOSS.

The HOT initiative was also discussed at a meeting of the [SME Envoy Network](#) (a group of national SME experts that provides policy advice to the European Commission). While the group expressed strong support for the one stop shop principle, they did stress the importance of the optional nature of such a measure for SMEs. Participants also highlighted that SMEs should be provided with clear and accessible guidance to explain what the consequences of HOT would be.

The changes the proposal would bring

The Commission tabled its [proposal](#) for a Council directive establishing a head office taxation system on 12 September 2023, as part of a wider [SME relief package](#). Dependent on certain conditions, the HOT proposal would allow small companies to continue using the corporate tax rules of their head office – i.e. the rules they are already familiar with – when they expand across borders. The directive would enter into force on 1 January 2026.

As noted above, in the impact assessment, the European Commission acknowledged that HOT **'could be seen as a complement'** to the VATOSS.

Scope and eligibility

Businesses would be eligible to make use of the HOT system if they comply with a range of criteria.

First, businesses would have to be either a **micro-, small or medium-sized enterprise**, as defined in [Directive 2013/34/EU](#).

Table 1 – EU enterprise size categories as defined in Directive 2013/34/EU

	Balance sheet total	Net turnover	Average no of employees	
Micro-enterprises	< €450 000	< €900 000	< 10	Once an enterprise exceeds the limits of at least two of the three criteria, it moves up to a higher business size category
Small enterprises	< €5 000 000	< €10 000 000	< 50	
Medium-sized enterprises	< €25 000 000	< €50 000 000	< 250	

Source: [Directive 2013/34/EU](#).

In addition, only those micro-enterprises and SMEs that **operate exclusively through PEs** in one or more Member States other than their own would be eligible for the HOT system (Article 2). The rules on the identification of those PEs would remain subject to the relevant bilateral tax agreements between countries, or in their absence, to national law (Article 3(1)).

The key provision of HOT would be that the head office would be able to choose to apply domestic taxation rules (**'head office taxation rules'**) in respect of its PEs in other Member States – i.e. the rules the company is already most familiar with.

In order to reduce the risk of aggressive tax planning, applying to HOT would be subject to three conditions (Article 4):

- the PEs' joint turnover could not have exceeded, for the last two fiscal years, an amount equal to or greater than double the turnover generated by the head office;
- the head office would have to have been resident for tax purposes in the current Member State for at least two fiscal years;
- the head office would have to be a micro-, small or medium-sized enterprise as defined by Directive 2013/34/EU.

To start applying head office taxation rules, the head office would have to file an application with the local tax authority, which would check whether the head office complied with all the conditions listed above. The tax authority of the head office's Member State would have to verify the eligibility requirements within 2 months, and inform its counterparts in the Member State(s) where the PEs were located (**host Member States**). This information exchange would take place by revising Council Directive 2011/16/EU, better known as the Directive on Administrative Cooperation in Tax Matters (DAC).¹⁰ The host Member States would be able to challenge the decision made by the head office's Member State regarding fulfilment of the eligibility requirements.

As with the VAT OSS, HOT would be a **voluntary scheme** and companies would be free to continue applying local tax rules for PEs in the different Member States.

Application of head office taxation rules

The head office would not be able to choose to which PEs it applied the head office taxation rules: it would have to apply the rules to **all its PEs**, including newly established ones (Article 4(2)).

Once a company joined the HOT system, the head office would have to apply the head office taxation rules to its PEs for a period of **5 years** (Article 7). The 5-year period would end prematurely in the event of a change in tax residence by the head office, or if the joint turnover of the PEs exceeded an amount equal to triple the turnover of the head office in the last 2 years (Article 8).¹¹ These termination conditions are designed to limit the risk of aggressive tax planning.

During application of head office taxation rules, the head office would file with its local tax authority a tax return covering its own tax liability as well as the tax liability of each PE in the host Member State(s). While the head office would apply the tax rules of its own Member State to calculate the taxable result, it would have to continue to apply the applicable **national tax rates** of the host Member States to calculate its overall tax payment. The tax authority of the head office's Member State would share the tax return with its counterparts in the host Member States, alongside other relevant information, which would help the host Member State identify the correct taxable result (Article 11).¹² The tax authority of the head office would collect the overall tax payments and allocate the relevant amounts to the respective host Member States.

The HOT system would not affect any national rules regarding local tax audits, legal proceedings or dispute resolution mechanisms. Host Member States could request a joint audit together with the authorities of the Member State of the head office to verify whether the taxable results of the PEs were filed correctly by the head office (Article 13).

After 5 years of application of the directive, the Commission would examine and evaluate it and make its findings available to the European Parliament and Council. This would be accompanied by a proposal to change the HOT system if needed (Article 19).

Design choices

HOT's scope remains restricted to standalone micro-enterprises and SMEs (i.e. operating exclusively through PEs). The [impact assessment](#) examined the possibility of extending the scope of HOT to subsidiaries, but as subsidiaries have their own legal personality in the other Member State, including them in HOT would have encroached further on the tax sovereignty of Member States, lowering the likelihood of unanimous support for such a proposal in Council, according to the Commission.

Furthermore, the proposal for 'Business in Europe – Framework for Income Taxation' ([BEFIT](#)) would allow SMEs with subsidiaries to join the BEFIT framework; a tax simplification system targeted at large multinationals. In this sense, HOT and BEFIT can be seen as complementary proposals, with HOT being particularly targeted towards businesses in their early stages of expansion (e.g. start-ups and scale-ups). A company outgrowing the HOT rules could choose to join BEFIT instead.¹³

As with the VAT OSS, HOT would remain a voluntary scheme. In its impact assessment, the European Commission [argued](#) that making HOT mandatory would have risked leading to discriminatory tax treatment for foreign taxpayers. For example, if an SME's PE is located in a Member State where the tax base is narrower than the Member State in which the head office is located, a mandatory HOT system would lead to the PE being treated unequally compared with domestic taxpayers.

Impact

Companies using the HOT system would need to spend less time and resources on understanding and complying with different corporate tax rules. As a result, **corporate tax compliance costs could be reduced by 32% for each firm using the HOT simplification**, according to Commission estimates. Those savings in compliance costs could then be used for a number of other purposes, such as wages, innovation, environmental activities or corporate expansion.

Total compliance costs could be lowered by €1.3 billion to €3.4 billion yearly across the EU, with further positive impacts on EU gross domestic product, competitiveness and tax revenue. Such estimates would be dependent not only on the HOT proposal itself, but also on the number of micro-enterprises and SMEs operating cross-border. To calculate the above-mentioned estimates, the Commission put forward two scenarios whereby either 5% or 10% of purely domestic firms start operating cross-border as a direct result of HOT. Such scenarios are merely illustrative and thus estimates may vary strongly, dependent on the overall health and efficiency of the single market.

Advisory committees

The European Economic and Social Committee (EESC) adopted its [opinion](#) in January 2024. Overall, the EESC is supportive of the proposal, welcoming the tax simplifications for small companies, and hopes that the file can be adopted in the Council without delay. While the EESC agrees with the Commission's proposed scope at this time, it encourages the Commission to explore in a future review whether the HOT system could be extended to SMEs operating cross-border through subsidiaries. Member States and the Commission should also work with organisations representing SMEs to raise awareness of the available HOT mechanism in order to guarantee a positive take-up.

National parliaments

National parliaments were invited to submit reasoned opinions under the [subsidiarity control mechanism](#). The deadline was 15 January 2024.

The Swedish Parliament submitted a [reasoned opinion](#), arguing the proposal was in breach of the subsidiarity principle. While welcoming the Commission's objective to simplify small companies' tax compliance, the Swedish Parliament criticised the departure from the international norm of taxing a permanent establishment as an independent enterprise in the country in which it operates. Furthermore, it noted that, if implemented, permanent establishments operating in the same Member State could be taxed differently, depending on where their respective head offices are

located. The Swedish Parliament expressed its concern that this might lead to tax planning opportunities, with deliberate relocations of head offices towards countries with the most favourable corporate tax systems.

Similarly, in a [letter](#) to the European Commission, the Czech Parliament's Committee on European Affairs argued HOT breached the subsidiary principle. It also expressed concern that HOT might lead to a relocation of head offices towards Member States with the most favourable tax systems.

Stakeholder views¹⁴

A [press release](#) by SMEUnited – an EU-wide employers' organisation representing small businesses – welcomed the HOT proposal, noting it had 'potential to significantly reduce administrative burdens and compliance costs for SMEs'.

Technology Industries Finland ([TIF](#)) – an organisation representing some 1 800 companies active in the Finnish technology industry – liked the principal idea behind HOT, but believed that very few of its members operated under a permanent establishment structure. TFI therefore encouraged HOT to expand towards SMEs operating cross-border through subsidiaries. More efforts should be taken as well to increase the HOT system's attractiveness, for example by extending it towards other taxes than solely corporate income tax.

Similarly, the Luxembourg Employers' Association ([UEL](#)) endorsed the overarching goal of HOT, but was worried that the impact – under the proposal's current design – would be 'fairly limited'. Therefore, next to extending the scope towards SMEs with subsidiaries, UEL suggested to use the one-stop shop nature of HOT as a starting point to expand towards other taxes and legal requirements (e.g. payroll taxes or business permits), to further lower compliance costs for companies. It also called on Council to include a specific procedure to deal with disputes when a Member State disagrees with a PE's tax assessment.

Legislative process

The Commission tabled its HOT proposal on 12 September 2023, as part of a wider relief package for SMEs. The proposal falls under a special legislative procedure requiring unanimous support in the Council, following consultation of the European Parliament and the EESC ([2023/0320\(CNS\)](#)).

In Parliament, the proposal was assigned to the Committee on Economic and Monetary Affairs (ECON), with Lídia Pereira (EPP, Portugal) as rapporteur. The European Parliament adopted its (non-binding) [resolution](#) in April 2024. The resolution strongly supports the overall proposal and underlines the serious need to reduce tax compliance costs for SMEs. To enable more companies to benefit from the simplifications, the resolution proposes to extend the HOT system's scope to companies that operate through no more than two subsidiaries (along with companies operating exclusively through PEs). It also asks for an advanced roll-out, with HOT applying from January 2025 (rather than 2026). Roll-out should be preceded by a multilingual information-campaign targeted at SMEs, to increase awareness (and ensure sufficient take-up) of HOT.

In the Council, the proposal is being discussed in the Working Party on Tax Questions (Direct Taxation). In June 2024, the Council [took](#) stock of the file's state-of-play. The Belgian Presidency of the Council had initiated in-depth discussions on several aspects of the proposal, including the procedural administration of HOT. While delegations generally supported the objectives of the proposal, a number of them expressed serious concerns concerning several aspects of HOT, such as the administrative or aggressive tax planning challenges it may create for tax authorities, competitiveness risks and broader concerns about the preservation of tax sovereignty.

The Council concluded that further discussions would be required in order to determine the next steps in the negotiations on HOT.

SOURCES

European Commission, [Communication – SME Relief Package](#), September 2023.

European Commission, [Head Office Tax System for SMEs](#), website, September 2023.

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](#), September 2023.

European Commission, [Proposal for a Council Directive on Business in Europe: Framework for Income Taxation \(BEFIT\)](#), September 2023.

European Parliament, [Establishing a Head Office Tax system for micro-, small and medium-sized enterprises](#), Legislative Observatory, OEIL.

ENDNOTES

- ¹ The study looked at tax compliance costs for the year 2019 by companies resident in EU-27 and the United Kingdom.
- ² At the time, the OSS was known as the 'mini one-stop shop' (MOSS) as it covered only a limited number of transactions. In mid-2021, it became the OSS.
- ³ Please note that this is a brief simplified introduction to the VAT One Stop Shop. See [VAT on e-Commerce – One Stop Shop](#) for more information.
- ⁴ The OSS remains a voluntary scheme, and businesses can continue to register and file local VAT returns in each country where they make a sale if they so wish.
- ⁵ The European Commission put forward a proposal in 2022 to broaden the OSS further ([VAT in the digital age](#)). If supported by the Council, the OSS will be opened to a wider range of transactions.
- ⁶ VAT is a major revenue source for EU Member States, representing roughly one fifth of all tax revenue collected within the EU. VAT is also an EU 'own resource', with Member States automatically allocating a share of their VAT collection to the EU budget. In 2023, [€22 billion](#) worth of VAT revenue was paid into the EU budget, representing 14 % of the EU's overall budget revenue of that year.
- ⁷ This is a simplified summary of the permanent establishment concept. PEs remain a complex tax matter, and it is crucial to always check the relevant bilateral tax agreement, national law and case law.
- ⁸ This example was taken from the Organisation for Economic Co-operation and Development (OECD) [Commentary to the Model Tax Convention on Income and Capital](#).
- ⁹ The public consultation was launched under the framework of the BEFIT proposal (Business in Europe – Framework for Income Taxation).
- ¹⁰ The DAC has developed as the main framework for information exchange between the tax authorities of Member States. Tax authorities in the EU currently share country-by-country reports on multinationals, information on cross-border tax arrangements, bank account data, etc.
- ¹¹ The draft directive sets out a clear timeline for businesses that would like to renew application of the head office tax rules after the initial 5 years. Those companies would need to file an application at least 6 months before the end of the 5-year period. Tax authorities would have 2 months to check whether the company still met the eligibility requirements.
- ¹² This exchange would take place under the framework of the DAC (see endnote 10).
- ¹³ A situation where SMEs with subsidiaries could have joined either HOT, BEFIT or neither likely would have led to inconsistencies and complexity, the Commission argued.
- ¹⁴ This section aims to provide a flavour of the debate and is not intended to be an exhaustive account of all different views on the proposal. Additional information can be found in related publications listed under 'European Parliament supporting analysis'.

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