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Is Home State Taxation a step forward for
SMEs?

An SME's ability for growth and integration in the EU
after the HST tax reform

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Summary

Small and Medium sized Enterprises (SMEs) within the European Union are currently facing many challenges one being access to financing due to high risk and probability of default, another being cross-border taxation issues with double taxation and information asymmetry. Since the aim¹ within the EU is to be the most competitive and dynamic knowledge-based economy in the world with sustainable economic growth and social cohesion it is essential that the EU operates as a single market.

Despite this need, harmonization continues to be far from achieved in the area of direct taxation which also affects the integration and growth opportunities for SMEs. In the *Agenda for Entrepreneurship*, the Home State Taxation regime, which is based on formula apportionment, has been proposed by the Commission as one option in order to mutually recognize the different Member States' taxation systems to facilitate cross-border activities and reduce 'red-tape'.

The 'red tape' exists as there are currently 25 different tax regimes within the EU, with varying requirements, administrations and laws concerning the conduction of business in the country. By analyzing the current situation of SMEs within the EU using the SWOT- and 4 Risks- analyses, applied to the SMEs based on research, cross-border issues become apparent which hinder SMEs from growing and adopting cross-border activities.

The *Agenda for Entrepreneurship* and the Home State Taxation proposal aims to improve cross-border activity through increasing financing opportunities for SMEs, and reduce pressing issues including transfer pricing, thin capitalization, the transfer of foreign losses and double-taxation which often lead to increased costs when operating cross-border. Although the proposed taxation regime indicates that these issues will be reduced or eliminated upon implementation, Member State reactions from EU case law including *Lankhorst-Hohorst* on thin capitalization, as well as institutional and academic criticism on the question of equal treatment and discrimination in regards to this regime, makes the actual implementation of Home State Taxation questionable. Furthermore, this proposed tax regime will not directly improve the accessibility of financing to SMEs, although, it will render cross-border activity less costly.

In order to improve the financial situation of SMEs, more accessible debt financing must be made possible for small sized SMEs who are between start-up and being financially established. As there is a lack of harmonization of direct taxation within the EU, the Home State Taxation proposal is a feasible alternative for companies to the current use of 25 tax regimes. More accessible debt financing combined with the implementation of HST would ensure the smooth integration and sustainable growth of the SME community. However, the dichotomy between Member States wanting to retain the power to tax and the freedom of establishment under the EC Treaty makes the implementation of HST using an apportionment formula less likely. Therefore, in order to ease the burden of cross-border expansion for SMEs the focus ought to be aimed away from tax reforms and towards making debt financing more accessible.

¹ Lisbon European Council *Bulletin of the European Communities* No. 6/1992

Preface

The interest in the topic of tax law and Small and Medium-sized enterprises started in October 2004 when I attended a presentation by the Managing Director of ALMI in Uppsala. The following months were spent gathering information and finding out more on the subject. It was exciting and challenging to discover the intricacies of EC tax law and the world of SMEs. This thesis is the result of these discoveries.

I would like to thank my tutors, Cécile Brokelind and Jens Forssbaeck for their encouragement to pursue. I would also like to thank Greg Batcheller of DuoCort AB, for giving me insight and first hand knowledge about SMEs. Lastly, I would like to thank my family for their unwavering love, support and encouragement.

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Abbreviations

AG	Advocate General
CO	Closely Held Company
DTC	Double Taxation Convention
ECJ	European Court of Justice
HST	Home State Taxation
IAS	International Accounting Standards
PD	Probability of Default
RBV	Research Based View
ROI	Return on Investment
SME	Small and Medium Sized Entities

1 Introduction

Small and Medium-sized Entities (SMEs) face particular challenges within the European Union. They currently have difficulty growing and expanding cross-border partly due to financing risks and administrative burdens, but also due to commercial, legal and political risks. “Finance is [...] an increasingly pressing issue”² for SMEs both due to financing availability and eligibility. It is difficult for an investor to gauge an SME’s financial stability, especially cross-border, due to information asymmetry. Furthermore, there is currently a lack of tax harmonization within the European Union. Expanding cross-border involves an incursion of additional costs due to differences in taxation and legal requirements which are comparatively higher for SMEs than for larger companies merely due to the small scale of operation. These issues hinder SMEs from cross-border expansion and integration within the European Union single economic market.

Since tax harmonization, a key element in achieving a single economic market, has not yet been fulfilled, four proposals have been put forth by the Commission to improve growth and integration within the European Union. These proposals are a voluntary harmonized tax base, a voluntary EU-wide Corporate Income Tax Scheme, a compulsory replacement of national rules with harmonized ones, and voluntary Home State Taxation (HST).³ HST is based on the principles of mutual recognition and the apportionment formula whereby the profits and losses incurred by secondary establishments in one Member State will be taxed according to the taxation rules of the Member State where the parent company has its principle establishment.

² EU Commission Communication: European Agenda for Entrepreneurship COM(2004) 70 final, p. 4

³ EU Commission Staff Working Paper *Company Taxation in the Internal Market* SEC (2001) 1681, p. 14

The Commission discusses HST more specifically for SMEs in the *Agenda for Entrepreneurship*⁴. A five year HST pilot project open only to SMEs was proposed by the Commission and supported both by SMEs and by the European Association of Craft, Small and Medium-sized Enterprises.⁵ This thesis will discuss the financial, resource and environmental situation and the growth and cross-border hindrances of SMEs in light of the HST proposal and determine the effects of HST on the situation examined.

In order to determine the current situation of SMEs, literature is described in order to create a foundation for the analysis. This literature covers not only the Commission SME definition, but also the difference between large and small firms, the financial growth cycle of small firms, and ownership structures and risk associated with small firms. Furthermore, the Agenda for Entrepreneurship is described in order to create a platform for integrated business and legal analysis of the affects of the HST proposal on the SME situation.

The SWOT analysis and the 4 Risks analysis are used as analytical tools to expand on the background information and to highlight in more detail the financial and resource opportunities and hindrances on SMEs. By applying these tools, the SME challenges and cross-border expansion issues including taxation issues, asymmetric information and access to financing will be specified in order to understand more thoroughly why the Home State Taxation reform has been proposed and what effects it could have. The basis of HST, its pros and cons as well as recent EU case law is then described and analyzed in accordance with the analytical framework in order to determine how this proposed taxation system could affect the financial, resource and environmental situation of SMEs and whether it is a

⁴ Ibid. EU Commission Communication COM(2004) 70 final. p. 4

⁵ EU Commission *Summary Report on replies received in response to the questionnaire on corporate tax as barrier to EU expansion of SMEs* TAXUD E.1/DOC (05)2301, 18 January 2005, p. 4 and UEAPME Position Paper on the consultation paper from DG TAXUD. March 14, 2003. p. 2-3

step forward in improving opportunities for growth and integration within the single European economic market.

1.1 Purpose

The purpose of this thesis is three-fold. Firstly, to determine which factors are hindering cross-border SME activity. Secondly, to analyze the HST proposal in light of EC tax law and finally to determine which effects the proposal will have on the current cross-border situation of SMEs within the European Union.

In light of the purpose, the following guideline questions will be considered in this thesis:

1. What is the current situation of SMEs in the EU?
2. What are some of the factors which are hindering SMEs from cross-border activity within the EU?
3. What is HST and why this reform has been proposed?
4. How are the principles of HST aligned with or divergent from EC case law and the current direct taxation developments within the EU?
5. How will HST affect the situation of SMEs?

1.2 Delimitations

Due to the current direct tax harmonization issues within the EU it is assumed in this thesis that harmonization of direct taxation will not occur in the near future.

Although the Commission has proposed four different options for tax reform⁶, only HST will be considered as a comparison of these different

⁶ Commission Staff Working Paper SEC (2001) 1681

proposals goes beyond the scope of this thesis. Furthermore, entrepreneurship will not be considered in particular. International conventions and double-tax treaties as well as specific EU directives and the Basel II accord will not be considered except for in passing.

Since the HST pilot project is only open to SMEs, the effects of HST will only be considered for this type of company.

This thesis looks at SMEs in general, without specifying a certain size of SME, the research on financing will be considered in general between equity and debt and will not analyze in detail the various types of financing or on internal versus external financing.

Legal principles and tax harmonization issues within the EU will only be briefly mentioned in order to provide a general understanding of the current taxation and harmonization situation in the EU.

1.3 Material and Disposition

The material used in this thesis is predominantly academic literature and articles. Commission publications, European Court of Justice case law and empirical research have also been used.

2 Methodology

This thesis is a result of abductive, that is, combined deductive and inductive research and is of traditional economic and legal methodology using the qualitative research method. Furthermore, the target audience is for students in this field of interest, and for those in the respective SME, finance and taxation related industries. It covers an integrated subject of business and law and thus some of the description and analysis combines the legal and business fields, while other chapters divide business and law in order to facilitate deeper analysis of the topic.

The interest in this topic began with the discovery of the *Agenda for Entrepreneurship*. Therefore this was the starting point of the thesis. After reading it, it was necessary to find out not only exactly what SMEs are and why they are so special, but also determine why the Agenda was proposed and why Home State Taxation might affect SMEs in a positive way. Thus, the three guideline questions (as seen in Chapter 1.1) arose: “what is the current situation of SMEs within the EU?”, “what are some of the factors which are hindering SMEs from cross-border activity within the EU?” and “what is HST and why this reform has been proposed?” The initial assumption was that Home State Taxation will solve the cross-border issues of SMEs and allow them to grow and integrate into the single European economic market.

Once these questions arose, academic literature was sought to answer firstly the SME-related questions. The first HST question was left for later research. Four articles in particular were chosen because they showed new empirical evidence of SMEs in the financial, resource and environmental realms. Firstly, the article by Thomas Dean⁷ was used to understand the differences of SMEs versus larger companies in an environmental or large

⁷ Dean, Thomas J. et al. *Differences in large and small firm responses to environmental context: strategic implications from a comparative analysis of business formations*. Strategic Management Journal Vol. 19. No. 8. p. 709-728

picture context. Although this article is dated from 1998, it highlights general differences to facilitate the understanding of why Home State Taxation is to be implemented as a pilot project on SMEs; the smaller companies are faced with different challenges both internally in the company, but also externally in relation to the corporate, economic and legal environment. This information facilitated the purpose of this thesis.

In order to understand why the Commission targets the SMEs in the Agenda in relation to financing, an article by Berger and Udell⁸ was appropriate to illustrate the financing structures of SMEs and how the sources and access to capital changes as SMEs grow in size and in age. The article exemplifies the financial growth cycle of SMEs, differentiates not only between internal and external financing, but also between different types of equity and debt financing which is accessible to different sized SMEs depending on both their age and their industry. Moreover, it describes the access to financing in relation to information asymmetry or opacity which is one factor which Home State Taxation aims to solve. Although this article does illustrate the basics of the financial growth cycle, a criticism of this article is that the results are not necessarily relevant for all types of SMEs.⁹ For the purpose of this thesis in looking at SMEs in the EU in general (without specifying a particular size), the basics of debt and equity financing of this article were described in order to understand the financial growth cycle, but only analyzed in a general way, without looking at the particularities of the various financing types.

Finally, two articles, one of Andersson and one of Dietsch, were used which highlight risk of SMEs according to the ownership structure and size.¹⁰ This

⁸ Berger, Allen N. and Gregory F. Udell, *The economics of small business finance: the roles of private equity and debt markets in the financial growth cycle*, Journal of Banking and Finance 22 (1998) p. 615, 622

⁹ Ibid. Berger, p. 622

¹⁰ Andersson et al, *Taxation of closely held companies*; Dietsch, Michel, Joël Petey *Should SME exposures be treated as retail or corporate exposures?*, Journal of Banking and Finance 28 (2004)

was an interesting supplement to the background of SMEs as it illustrates the issue of SME risk in another context.

Having gathered this information, it was necessary to choose an analytical model to place the SME situation into context which could then be examined with the addition of EC Tax Law in general and Home State Taxation in particular. Four different analytical tools were considered: SWOT analysis, Porter's Five Forces, Research-based View, and 4 environmental risks analysis. From these, the SWOT and 4 risks analysis were chosen. Porter's Five Forces was considered to be more applicable to large companies from an external standpoint, and since previous research illustrated that small and large companies differ in many ways, it was thus considered not appropriate to examine SMEs. Furthermore, the Research-based View considers the internal resources and capabilities of a company, and since this thesis is examining the effects of Home State Taxation on SMEs, it was considered not as relevant as using the SWOT and 4 risks analysis. Although the SWOT analysis as a strategic tool is considered by some to be more theoretical than practical¹¹ it was deemed the most appropriate tool in order to analyze the SMEs in light of the thesis topic. By choosing these two analytical tools, it facilitated not only a determination of the internal and external forces affecting SMEs as a company structure, but to further place the SMEs into a larger context through the 4 risks analysis which incorporates macroeconomic and political forces. The 4 risks analysis was chosen to broaden the context of factors affecting SMEs so that a European Union picture could be touched upon.

The European Union, from a legal point of view was considered next because the SWOT and 4 environmental risks analyses would not be complete without understanding the legal context of this integrated business and legal topic. As with any legal examination, the legal research began with the EC Treaty. The basics of EC Tax law as well as developments and

¹¹ Reimer, Richard. *The Financing of Projects as a Competitive Means*. Master Thesis, School of Economics and Commercial Law, Göteborg University. 1998

problems of harmonizing taxation within the EU were collected. This was essential information to consequently understand why Home State Taxation had been proposed.

Home State Taxation was considered next, starting with Lodin and Gammie's book *Home State Taxation*¹² who specialized in developing the Home State Taxation reform guidelines. As this book was written by those who see Home State Taxation as the answer to cross-border taxation issues, it was attempted to lose the initial assumption that the proposed tax reform would indeed solve cross-border issues. It was described and analyzed with a neutral viewpoint. This satisfied the third guideline question.

Before answering the fourth and fifth guideline questions, the initial SWOT and 4 environmental risks analysis were conducted in order to understand more of the intricacies of the SME financial, resource and environmental situation. Much of the thesis research was conducted in this section.

The fourth guideline question then arose: "how are the principles of HST aligned with or divergent from EC case law and the current direct taxation developments within the EU?" The case law was subsequently chosen in order to compare the decisions of the European Court of Justice with the fundamental elements of the proposed Home State Taxation reform in order to determine whether HST is aligned with Treaty-based case law.

Based on this research and analysis, it was then appropriate to analyze the SME situation with the legal research in order to fulfill the purpose of this thesis. The final guideline question arose: "How will HST affect the situation of SMEs?" This was used in order to complete the analysis and to draw conclusions.

¹² Lodin S.O. and M. Gammie, *Home State Taxation*, IBFD Publications BV 2001

Empirical Research

During the course of the research, several empirical resources were also used in order to supplement my findings. Firstly, a telephone interview with Barbara Schweighofer at the SME Union in Brussels was conducted in order to find out what the SME Union standpoint was on challenges of SMEs in general and whether they had heard of or had any relevant documents concerning Home State Taxation; several sources were offered in order to supplement my research, including *Successes and Challenges for SMEs*¹³ which was useful for the SWOT analysis. Also, an interview was conducted both in person and by e-mail with Greg Batcheller who is deeply involved with three SMEs¹⁴ here in Lund, Sweden. Although it is only one empirical source concerning my topic, this interview facilitated not only the confirmation of SME issues and the current situation based on research, but it also facilitated the understanding of the issues from someone who is living the issues.

Furthermore, a Svenskt Näringsliv conference presentation¹⁵ by Professor Richard Scase who is “author, academic and entrepreneur – [...] one of the UK's leading business strategists and authoritative business forecaster of scenarios for this century”¹⁶ was then used because it was a dynamic presentation specifically oriented towards innovation, motivation and SMEs. Although the topic was not directly related to my specific area of research, it was a useful supplement as background and as a part of the SWOT and 4 risks analysis. The audience of this presentation was corporate community in Sweden, and thus it was an interesting addition to my research considering it was extremely straightforward, active and realistic.

¹³ Brennan, Caroline *Successes and Challenges for SMEs*, SME Union

¹⁴ Three SMEs are: NeuroPharma AB, DeNova Stella AB, DuoCort AB

¹⁵ Scase, Prof. Richard, *A world class Sweden? Living in the Corporate Zoo – Life and Work in 2010*, Svenskt Näringsliv Conference Presentation, 4 April 2005, SVT24

¹⁶ <http://www.futurescase.com>, April 4, 2005

3 Background and Theory

3.1 SME Background

3.1.1 SME Definition

Small and Medium Sized Companies comprise of over 90% of companies in the European Union.¹⁷ The Commission has defined SME's as follows:¹⁸

Enterprise category	Headcount	Turnover	or	Balance sheet total
Medium-sized	< 250	≤ € 50 million		≤ € 43 million
Small	< 50	≤ € 10 million		≤ € 10 million
Micro	< 10	≤ € 2 million		≤ € 2 million

SMEs already have a special place within the EU corporate community and within the EU legal framework. For example, SMEs are governed under the 'de minimis' rules concerning competition laws because it is considered that actions and activities of SMEs will have minimal effect upon the distortion of competition within the common market.¹⁹ Furthermore, SMEs are often partly financed through repayable or non-repayable government grants or State Aid under the "Commission Regulation on the applications of Articles 87 and 88 of the EC Treaty to State Aid to small and medium sized enterprises"²⁰. There is significant criticism concerning the current special treatment of SMEs both in regards to equal treatment as well as fundamental rights and non-discrimination principles.²¹ This criticism has become more

¹⁷ <http://www.eubusiness.com> January 16, 2005

¹⁸ http://europa.eu.int/comm/enterprise/enterprise_policy/sme_definition/index_en.htm October 24, 2004

¹⁹ Commission Notice (de minimis) 2001/C 368/07

²⁰ Commission Regulation No 70/2001

²¹ Deloitte EU Tax Group *Study on analysis of potential competition and discrimination issues relating to a pilot project for an EU tax consolidation scheme for the European Company Statute* TAXUD/2003/DE/305; reference to Art 12 EC and Art 14 ECHR

potent now that the European Company statute (Societas Europaea or SE) has come into effect.²² Although these issues are outside the scope of this paper, it is necessary to outline the current EU legal framework and issues surrounding SMEs.

3.1.2 Large versus Small Companies

Aside from the legal differences between large and small companies in terms of competition law, large and small companies also differ in their environmental context according to Dean, Brown and Bamford.²³ Through theoretical and empirical study, it was found that resources and capabilities as well as company formation differ between the two. Because of the size, larger companies can take advantage of scale economies and are less affected by sunk costs.²⁴ However, small companies are more attracted to niche-market industries in high-growth and high-technological fields; small companies are also less deterred by barriers to entry such as vertical integration and product differentiation as they pursue economic activity in highly specialized areas.²⁵ It was also found that small businesses have certain characteristics “which offer special opportunities for speed, flexibility, and niche-filling capabilities”²⁶. Their conclusion indicates that although there are deterrent effects for both large and small firms, in industries with high concentration, the small firms are less affected.²⁷

In a conference presentation for Svensk Näringsliv, Professor Scase presented another aspect which highlights the uniqueness of small companies.²⁸ This involves the motivation and commitment inherent in small companies and how this motivation changes as the company grows.

²² Ibid. Deloitte EU Tax Group; the SE Statute came into effect in October 2004

²³ Dean, Thomas J. et al. *Differences in large and small firm responses to environmental context: strategic implications from a comparative analysis of business formations*. Strategic Management Journal Vol. 19. No. 8. p. 709-728

²⁴ Ibid. Dean, p. 723

²⁵ Ibid. Dean, p. 724

²⁶ Ibid. Dean, p. 724

²⁷ Ibid. Dean, p. 72

²⁸ Ibid. Scase presentation, slide 30

An SME with one employee (ie. The founder), principally has maximum commitment, as the firm grows to beyond 50 employees, the motivation and commitment levels are labeled “nine to fives”²⁹ where commitment has to be encouraged by the management. Therefore, the type and level of motivation, flexibility, speed and niche-filling capabilities differentiates SMEs from larger companies.

3.1.3 SME Financing Sources

There are other sources of financing available to SMEs aside from the State Aid mentioned in section 2.1.1. According to Berger and Udell, the capital structure and financing sources of SMEs depend on perceived risk, age, size and information availability.³⁰ These all influence the capital structure which is available to SMEs. Furthermore, a distinction is made between internal and external equity financing during the course of the growth in size and age of the company.³¹ The level of risk is divided between high risk growth where SMEs have mostly intangible assets, and low risk growth with mostly tangible assets which can be used as collateral against a debt financing source.³² The internal versus external equity financing, micro-sized SMEs are typically financed through internal equity by the “principle owner” at start up where a formal business plan is formulated and where information about the company is typically confidential.³³

As the information becomes more transparent with the growth in size, age, and knowledge of the SME, the capital structure changes as well. The figure which Berger and Udell use to illustrate their findings on the age-size-information correlation is seen in the figure below. Although this figure has loopholes including that it does not apply for all small businesses,³⁴ it does

²⁹ Ibid. Scase, slide 30

³⁰ Ibid. Berger, p. 615, 622

³¹ Ibid. Berger, p. 615

³² Ibid. Berger, p. 624

³³ Ibid. Berger, p. 622

³⁴ Ibid. Berger, p. 622

give a general illustration of the capital structures available to SMEs. Figure 1 exemplifies sources of four equity and seven debt financing tools from which SMEs typically gain financial backing.

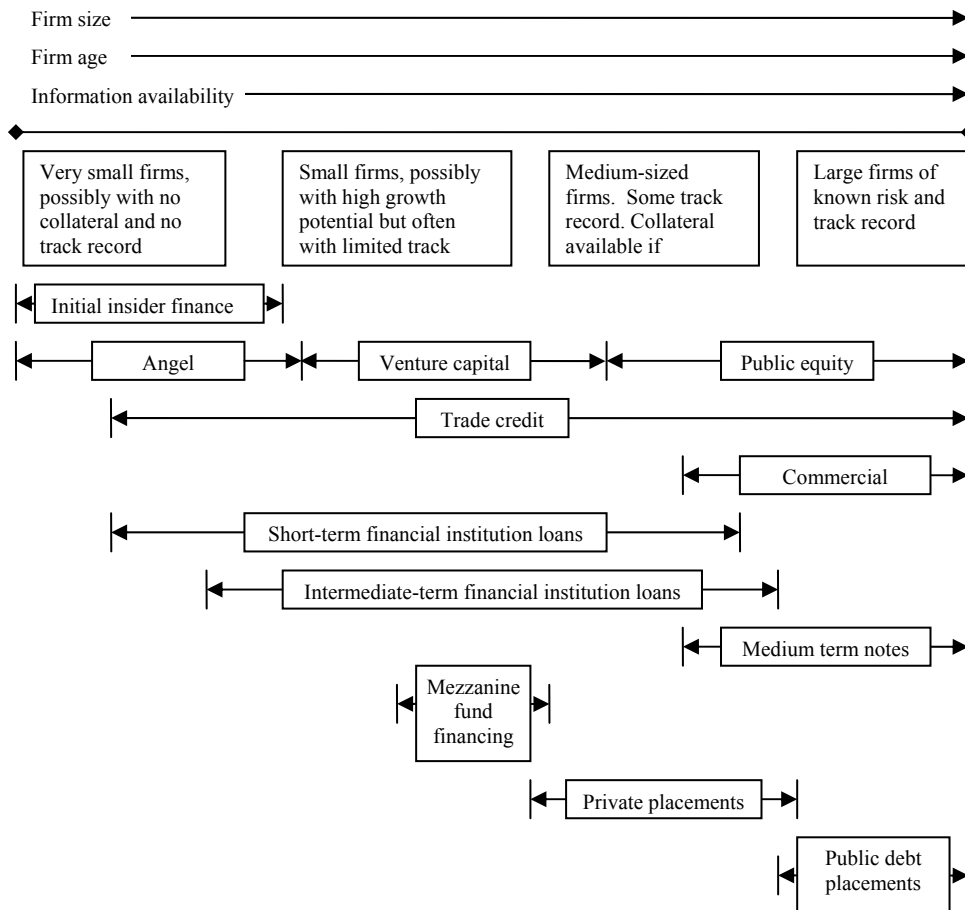


Figure 1. Firm Continuum and sources of finance³⁵

The sources of equity financing include:

- Initial insider finance;³⁶
- Angel finance;³⁷
- Venture capital;³⁸
- Other equity (from close family and friends).³⁹

³⁵ Ibid. Berger, p. 623

³⁶ Ibid. Berger, p. 620

³⁷ Ibid. Berger, p. 620

³⁸ Ibid. Berger, p. 620

³⁹ Ibid. Berger, p. 620

The sources of debt financing include:

- Commercial banks;⁴⁰
- Finance companies;⁴¹
- Other finance institutions;⁴²
- Trade credit;⁴³
- Other business;⁴⁴
- Government;⁴⁵
- Principal owner.⁴⁶

It was further found that high-growth and high-risk companies typically gain more external equity financing while the low-growth and low-risk companies finance more through external debt.⁴⁷ Furthermore, SMEs can typically not issue public shares or securities until later in the financial growth cycle due to the information opacity or asymmetry.⁴⁸

3.1.4 SME Ownership Structures and Risk

In the article *Taxation of Closely Held Companies – new empirical results*⁴⁹ taxation and financing issues are considered in light of different company, taxation and financing structures. The distinction is made between Closely held companies (CO) which are those with one or few owners, and broadly owned companies (BO) which are those with many shareholders.⁵⁰ Andersson also specifies that CO can be used interchangeably with SME.⁵¹

⁴⁰ Ibid. Berger, p. 620

⁴¹ Ibid. Berger, p. 620

⁴² Ibid. Berger, p. 620

⁴³ Ibid. Berger, p. 620

⁴⁴ Ibid. Berger, p. 620

⁴⁵ Ibid. Berger, p. 620

⁴⁶ Ibid. Berger, p. 620

⁴⁷ Ibid. Berger, p. 626; this is referring to the possibility of low-risk firms to offer tangible assets as collateral.

⁴⁸ Ibid. Berger, p. 626

⁴⁹ Ibid. Andersson

⁵⁰ Ibid. Andersson, p. 9

⁵¹ Ibid. Andersson, p. 3, footnote 3

The empirical study of taxes, profitability, financing options, entrepreneurship, company size and growth are evaluated in order to determine taxation levels of COs as opposed to BOs and consequent financing mixtures of debt and equity relative to the risk levels of these two types of companies. Although the debt and equity financing mixtures is considered, Andersson does not make a distinction between internal and external financing. It is hypothesized that COs are more risky undertakings than BOs because COs generally have high risk profiles with high corporate tax rates that require a high rate of return (ROR) to be profitable.⁵² Consequently, the high ROR required means a high solvency margin is needed.⁵³ Usually, debt financing through banks will only be feasible up to a certain risk level. This explains why COs usually have to seek more equity financing.⁵⁴

Tax rates for COs are higher, partly because a large part of return is taxed as labour income.⁵⁵ Especially where taxation structure is progressive, there are several layers of taxation compounded together which results in the marginal taxation rate for COs to be much higher than the average tax rate.⁵⁶ Consequently, the higher the return, the more the company is taxed, which thereby lowers the profit margin.⁵⁷ Furthermore, since banks “avoid high risk”⁵⁸ the financing for COs need to come from other forms of equity financing.

Due to high levels of equity financing, it is considered that COs are less risky than other corporate loan portfolios.⁵⁹ According to Andersson, COs are thought to require less economic capital and consequently also have

⁵² Ibid. Andersson, p. 9

⁵³ Ibid. Andersson p. 1

⁵⁴ Ibid. Andersson, p. 2

⁵⁵ Ibid. Andersson, p. 3

⁵⁶ Ibid. Andersson, p. 3

⁵⁷ Ibid. Andersson, p. 3

⁵⁸ Ibid. Andersson, p. 4

⁵⁹ Ibid. Andersson, p. 4

smaller losses, however this interpretation can be thought to be due to the high levels of equity financing.⁶⁰

According to the empirical results, the hypothesis that COs have a higher risk level than BOs is untrue. COs were found to have higher profitability than BOs. One reason explaining this result is possibly the difference in financing costs where COs have fewer assets and a higher solvency margin.⁶¹ This conclusion can be compared to Berger in that high-risk firms gain more financing from equity.

It is considered that there is a “significant positive correlation between economic growth and the level of entrepreneurship”⁶². Since SMEs make up almost 90% of the corporate community within the EU, this implicates that few of these firms grow.⁶³

Another reason for limited growth among the SME community is addressed by Dietsch and Petey in an analysis of the probability of default (PD) of SMEs.⁶⁴ Three sizes of SMEs are defined as small with up to €1 million in turnover, medium with turnover between €1 million and €7 million, and large with between €7 million and €40 million. In order to remain consistent with the Commission definition of SMEs⁶⁵, the sizes referred to will be micro⁶⁶, small⁶⁷ and medium⁶⁸. Dietsch found that micro SMEs are less risky than small SMEs, and medium SMEs are the least risky.⁶⁹ Therefore, not only do small SMEs have the highest risk which implicates the debt

⁶⁰ Ibid. Andersson, p. 4

⁶¹ Ibid. Andersson, p. 10

⁶² Ibid. Andersson, p. 14

⁶³ <http://www.eubusiness.com> January 16, 2005; Scase, Prof. Richard, *A world class Sweden? Living in the Corporate Zoo – Life and Work in 2010*, Svenskt Näringsliv Conference Presentation, 4 April 2005, SVT24 – Scase addresses the issue that few SMEs rarely grow as the companies are often sold before they become larger SMEs.

⁶⁴ Ibid. Dietsch

⁶⁵ See Chapter 2.1.1

⁶⁶ With up to €1 million in turnover

⁶⁷ With turnover between €1 million and €7 million

⁶⁸ With between €7 million and €40 million in turnover

⁶⁹ Ibid. Dietsch, p. 778

financing possibilities, but simultaneously indicates the difficulty in growing beyond a certain size.

3.2 European Union and SMEs

3.2.1 The European Agenda for Entrepreneurship

The *European Agenda for Entrepreneurship*⁷⁰ addresses the issue of SME growth and that there are not enough entrepreneurs within the EU. Their conclusion rests on two main issues. Firstly, the so-called ‘entrepreneurial mindset’ is not being fully exploited and secondly, that the encouragement to start a business or to pursue an innovative idea is lacking in financial incentives that could reduce the risk (and failure) factor.⁷¹ These issues are compared to the United States where entrepreneurship is more fully encouraged.⁷²

In order to lessen the “productivity gap”⁷³ between the EU and the United States, two questions are posed: “How to produce more entrepreneurs?” and “how to get more firms to grow?”⁷⁴ The Commission’s answer to these questions is to encourage entrepreneurial courses at schools and universities, and to create ways to overcome financial burdens which arise often for small businesses.

Creating an entrepreneurial mindset, and to develop creative and ambitious minds to realize business goals is extremely important for quieting a fear of failure. It is considered that, if you take a higher risk, you should get a

⁷⁰ Ibid. EU Commission Communication COM(2004) 70 final

⁷¹ Ibid. EU Commission Communication COM(2004) 70 final, p. 3

⁷² The EU-US entrepreneurship comparison was also criticized by Prof. Richard Scase in his presentation *A world class Sweden? Living in the Corporate Zoo – Life and Work in 2010*, Svenskt Näringsliv Conference Presentation, 4 April 2005, SVT24

⁷³ Ibid. EU Commission Communication COM(2004) 70 final, p. 3

⁷⁴ Ibid. EU Commission Communication COM(2004) 70 final, p. 4

higher return. However, in start-up companies and small businesses, there is often more risk than return as evident in the PD of SMEs.⁷⁵

According to the Commission “deficiency in credit provision to small enterprises is explained by its high transaction cost and the financial providers' perception of a high risk and low return activity.”⁷⁶ Thus there is a high chance of failure in starting a small business.⁷⁷ Therefore, in order to make use of the financial incentives mentioned, such as changes in taxation and in state aid to help small businesses get off their feet, it is a necessity to lessen the risk factor so that potential entrepreneurs can make use of the financial incentives put forth.

Since the aim⁷⁸ within the EU is to be the most competitive and dynamic knowledge-based economy in the world with sustainable economic growth and social cohesion, the Commission addresses the (financial) growth of SMEs in relation to incentives for cross-border expansion in the single economic market.⁷⁹ Financial incentives proposed by the Agenda are addressed because it is considered that “finance is seen as an increasingly pressing issue”⁸⁰. Taxation for example, involves “complying with different national tax laws and regulations [which is] an obstacle to cross-border activities.”⁸¹ Therefore, the Commission has proposed Home State Taxation as a solution to reducing the perceived risk factor and increase cross-border activity where taxable profits of a company are taxed in its home State.⁸²

⁷⁵ Ibid. Dietsch, p. 778

⁷⁶ <http://www.eubusiness.com/topics/SMEs/sme.2005-01-10> February 28 2005

⁷⁷ Ibid. Dietsch, p. 778

⁷⁸ Lisbon European Council *Bulletin of the European Communities* No. 6/1992

⁷⁹ Ibid. EU Commission Communication COM(2004) 70 final, p. 4

⁸⁰ Ibid. EU Commission Communication COM(2004) 70 final, p. 4

⁸¹ Ibid. EU Commission Communication COM(2004) 70 final, p. 16

⁸² Ibid. EU Commission Communication COM(2004) 70 final, p. 16

3.2.2 European Agenda Developments

Since the Agenda there has been extensive analysis of the proposed pilot scheme which is meant to last for a predetermined time span of approximately five years. The Commission has found that one-third of the SMEs within the EU consider corporate taxation to be an obstacle when considering expanding cross-border.⁸³ Furthermore, approximately half the SMEs considered the HST proposal as a positive development and would consider participating in the five-year project; the majority of interested parties being medium-sized SMEs.⁸⁴

In order to aid financing in accordance with the Agenda, there are currently initiatives underway in the EU to financially help SMEs. The project, “The Small and Medium-size Enterprise Finance Facility” has been established in order to finance SME’s with 6 million Euros per year for six years. This project has been initiated in conjunction with international financial institutions including the European Investment Fund (EIF), the European Investment Bank (EIB), the European Bank for Reconstruction and Development (EBRD), and the Kreditanstalt für Wiederaufbau (KfW).⁸⁵ This project aims to improve confidence, and the ability and capacity of credit institutions to finance SME’s.⁸⁶ This is a promising project that can improve the growth and sustainability of SME’s, however, these are predominantly available only for the accession Member States and other Baltic countries.⁸⁷

⁸³ EU Commission *Summary Report* TAXUD E.1/DOC (05)2301

⁸⁴ See Chapter 2.1 for Commission definition of SMEs

⁸⁵ <http://www.eubusiness.com/topics/SMEs/sme.2005-01-10> January 16, 2005

⁸⁶ <http://www.eubusiness.com/topics/SMEs/sme.2005-01-10> January 16, 2005

⁸⁷ <http://www.ebrd.com/apply/small/index.htm> February 20 2005

3.3 The current SME Situation

In light of the SME definition, background theory, and the *European Agenda for Entrepreneurship*⁸⁸ the dependant variable to be examined will be defined in order to determine the effects the HST proposal will have on SMEs. Where the Agenda addresses the current SME hindrances to grow and expand cross border, the dependant variable will be defined as *the SME situation* where the economic, resource and environmental factors which may be adding to the current hindrances will be examined. The finance and growth will be used according to the Agenda whereby it predominantly addresses cross-border expansion.

3.4 Choice of Analysis Framework

In order to analyze the current SME situation, there are several possible analytical frameworks to choose from; the SWOT analysis⁸⁹, Porter's Five Forces analysis⁹⁰, Research Based or Competency-based analysis (RBV)⁹¹ and finally environmental risks analysis⁹².

The SWOT analysis became a popular strategic tool for companies in the 1960s.⁹³ It is considered to be an analysis tool which simultaneously considers both the external environment and the internal one.⁹⁴ However, as a strategic tool, it is considered to be more theoretical than practical.⁹⁵

⁸⁸ Ibid. EU Commission Communication COM(2004) 70 final

⁸⁹ Andrew, Kenneth R.. *The Concept of Corporate Strategy* Ed. 3 Richard D. Irwin Publishing: 1987

⁹⁰ Porter, Michael, *Competitive Strategy – Techniques for Analyzing Industries and Competition*, Free Press: New York 1980

⁹¹ Collis, David J. and Cynthia A. Montgomery. *Competing on Resources Strategy in the 1990s*. Harvard Business Review July/August 1995

⁹² Bartlett, CA & S. Ghoshal *Building Strategic capabilities: the competitive challenge*, Transnational Management, 1994

⁹³ Dyson, Robert G. *Strategic development and SWOT analysis at the University of Warwick*, European Journal of Operational Research 152 (2004), p.633

⁹⁴ Ibid. Dyson, p.633

⁹⁵ Ibid. Reimer, p. 45

Porter's Five Forces, analyzes the external environment in relation to the threats of new entrants, and substitute products, and the bargaining powers of buyers and suppliers all in relation to the degree of rivalry among competitors⁹⁶. Since Porter's Five Forces is largely applicable to large companies, and where there are differences between large and small firms⁹⁷, this tool was not deemed the most appropriate analytical tool for the purpose of this thesis; the SWOT is more versatile to analyze small companies.

The most recent analytical model used is the RBV (Research Based View) tool which focuses predominantly on the internal capabilities of the company.⁹⁸ The RBV considers the core competence and capabilities of a company ranging from the inimitability of an internal resource to its durability and appropriability.⁹⁹ As the RBV analysis considers only the internal capabilities and resources which is not so relevant in the context of this thesis.

Lastly, the 4 risks analysis considers the external environmental risks which affect a company.¹⁰⁰ These include the macroeconomic, political or policy risks, competitive risks and resource risks.¹⁰¹ This analysis framework will place the examination of the SME situation in a broader context and will facilitate the analysis of this topic.

In light of these analytical frameworks, therefore, the SWOT and 4 risks will be used in order to first learn of the internal and external factors directly affecting the SME situation, and following, to consider the larger picture to consider the impacts of external environment forces. The choice of SWOT and 4 environmental risks will facilitate the examination of how HST will

⁹⁶ Ruocco, Paul and Tony Proctor. *Strategic Planning in Practice: A Creative Approach*. Marketing Intelligence and Planning Vol. 12. No. 9. 1994. p. 27

⁹⁷ Ibid. Dean, p. 72; referring to Chapter 3.1.2

⁹⁸ Ibid. Collis, p. 119

⁹⁹ Ibid. Collis, p. 119-124

¹⁰⁰ Ibid. Bartlett, p. 244

¹⁰¹ Ibid. Bartlett, p. 244

affect the SME situation in the European Union in light of the Commission's Agenda.

4 The Current SME Situation

This chapter will elaborate on the background of SMEs within the EU. The guideline questions one and two - what is the current situation of SMEs in the EU, and, what are some of the factors which are hindering SMEs from cross-border activity within the EU – will be considered in light of the SWOT and 4 risks analyses frameworks.

4.1 SWOT Analysis

4.1.1 Strengths

Strengths according to the SWOT analysis are the internal strengths with which a company can create competitive advantage. SME strengths include:

- level of knowledge in the R&D field;¹⁰²
- employee motivation¹⁰³
- networking and knowledge transfer capabilities within the local SME community;¹⁰⁴
- ground breaking R&D results and patent-worthy products;¹⁰⁵
- close relationship through contract with collaboration partners;¹⁰⁶
- high growth potential¹⁰⁷ and “niche opportunities” due to product differentiation¹⁰⁸.

¹⁰² Greg Batcheller, DuoCort AB

¹⁰³ Scase, Prof. Richard, *A world class Sweden? Living in the Corporate Zoo – Life and Work in 2010*, Svenskt Näringsliv Conference Presentation, 4 April 2005, SVT24; employee motivation is extremely high in an SME with fewer than 10 employees

¹⁰⁴ Ibid. Scase, 4 April 2005, SVT24

¹⁰⁵ Greg Batcheller, DuoCort AB

¹⁰⁶ Greg Batcheller, DuoCort AB

¹⁰⁷ Ibid. Berger, p. 623, 627

¹⁰⁸ Dean, Thomas J., et al. *Differences in Large and Small Firm responses to environmental context: Strategic implications from a comparative analysis of business formations*, Strategic Management Journal, Vol 19, No. 8 (Aug 1998), p. 716

4.1.2 Weaknesses

Weaknesses are any hindrance or challenge within the company. These include any lacking capabilities within the firm itself which may be hindering competitive advantage and SME growth.¹⁰⁹ SME weaknesses include:

- lack of management skills and thus lack of business strategy;¹¹⁰
- weak or no business plan;¹¹¹
- inadequate funding¹¹² due to the high risk factor¹¹³ and requirement that public funding is matched by private equity;¹¹⁴
- information asymmetry compared to larger firms¹¹⁵ making it more difficult to find or know about funding available;
- high risk¹¹⁶ and PD;¹¹⁷
- have not implemented IAS due to costs outweighing benefits and ongoing discussion regarding the requirements of applying this standard for SMEs;¹¹⁸
- higher sunk costs which deters entrance to new markets.¹¹⁹

4.1.3 Opportunities

Opportunities include any external factor which poses an opportunity for a company to exploit in order to gain competitive advantage and to grow.¹²⁰

Opportunities for SMEs include:

¹⁰⁹ Turner, Myra Faye *How does your company measure up?* Black Enterprise Magazine, November 2001, p. 53

¹¹⁰ Greg Batcheller, DuoCort AB; R&D-based SMEs seem to have the technical know-how, but lack the management skills that will enhance the profitability and productivity of the SME

¹¹¹ Greg Batcheller, DuoCort AB

¹¹² Brennan, Caroline *Successes and Challenges for SMEs*, SME Union, p. 47

¹¹³ Andersson et al, *Taxation of closely held companies*, p. 15

¹¹⁴ Greg Batcheller, DuoCort AB

¹¹⁵ Ibid. Berger, p. 616

¹¹⁶ Ibid. Andersson p. 2

¹¹⁷ Ibid. Dietsch, p. 779

¹¹⁸ EuroChambres Position Paper *IAS for SMEs* September 2004, p. 3; IASB Discussion Paper *Preliminary views on accounting standards for small and medium-sized entities* June 2004; regarding EU Commission Regulation (EC) No 1606/2002

¹¹⁹ Ibid. Dean, p. 722

¹²⁰ Ibid. Dyson, p.632

- 2.2 billion Euros for R&D set aside by the EU for SMEs;¹²¹
- HST pilot project to encourage growth and entrepreneurship cross-border;¹²²
- Late Payment Directive (2000/35/EC) to help SMEs avoid additional financial burden due to late payments.¹²³

4.1.4 Threats

The threats SMEs are facing can be applied to most SMEs within the EU. These threats include:

- Lack of integration of financial services;¹²⁴
- Basel II Accord which will decrease risk rating results making financing opportunities more difficult to obtain;¹²⁵
- Administrative and legal burdens as well as “complying with different national tax laws and regulations”¹²⁶ when attempting to expand cross-border;¹²⁷
- Double-taxation risks;¹²⁸
- Transfer pricing issues;¹²⁹
- Thin capitalization rules;¹³⁰
- Liquidation or takeover by larger company¹³¹.

These threats can also be considered challenges, because if an informed and confident management team utilizes them, they can be translated into

¹²¹ Editorial Staff *European Union sets aside €2.2bn for small firms* Oracle Magazine Issue 2 April 2004, http://www.oracle.com/global/uk/emea_sme/april2004/eu_small.html

¹²² EU Commission Communication: European Agenda for Entrepreneurship COM(2004) 70 final, p.5

¹²³ Ibid. Brennan, p. 16; The Commission implemented the directive 2000/35/EC to combat the late payment of commercial transactions as it was found that excessive payment periods or late payments are a predominant reason for SME insolvencies.

¹²⁴ Ibid. Brennan, p. 66

¹²⁵ Ibid. Brennan, p. 45

¹²⁶ Ibid. EU Commission Communication COM(2004) 70 final, p. 16

¹²⁷ Ibid. EU Commission Communication COM(2004) 70 final, p. 6

¹²⁸ Ibid. EU Commission *Summary Report* TAXUD E.1/DOC (05)2301. p. 2

¹²⁹ Ibid. EU Commission *Summary Report* TAXUD E.1/DOC (05)2301. p. 2

¹³⁰ Ibid. EU Commission *Summary Report* TAXUD E.1/DOC (05)2301. p. 2

¹³¹ Ibid. Scase, 4 April 2005, SVT24

opportunities to provide competitive advantage. Furthermore, it would facilitate profitable cross-border SME activity.¹³²

4.2 4 Risks Analysis

”Opportunities and risks are often two sides of the same coin.”¹³³ The four risks consider the risk side of the coin, although these can be considered ‘simple’ enough to transform into opportunities.¹³⁴ These risks will illustrate the factors which affect the SME from the external environment; all these factors add to the cross-border hindrances and affect the SME’s cost of capital.

4.2.1 Macroeconomic Risks

According to Bartlett and Ghoshal, macroeconomic risks are any external factors which are outside of a company’s control. These include region or country specific risks as well as worldwide happenings such as war which can have a direct or an indirect effect on a company’s profitability. Furthermore, the risks such as changes in interest rates, exchange rates and wage levels can be considered macroeconomic risks.¹³⁵

Macroeconomic risks for SMEs include:

- Interest rate changes: will directly change the possibilities to obtain financing as well as change (increase) the cost of capital. Part of this risk involves the unexpected fluctuations in interest rates as well as the changes themselves;¹³⁶
- Exchange rate changes: will directly affect the SME, especially if it is considering expanding cross-border or is supplying or purchasing to or

¹³² Ibid. Reuber, p. 808-810

¹³³ Ibid. Bartlett, p. 244

¹³⁴ Ibid. Bartlett, p. 244

¹³⁵ Ibid. Bartlett, p. 244; Oxelheim, Lars and Clas Wihlborg *Managing in the Turbulent World Economy*. John Wiley & Sons: West Sussex. 1997. p. 22-27

¹³⁶ Ibid. Oxelheim, p. 27

from abroad.¹³⁷ Like interest rate changes, the risk and effect on cross-border economic activity increases with the “likelihood and magnitude of unexpected changes”¹³⁸.

- Workers Unions: which may also have quite an influence on the SME in terms of wage levels. Both national unions in countries like Sweden where these are strong, as well as the SME Union¹³⁹ will have influence;
- Information asymmetries about capital market frictions: can have a more negative effect on SMEs than larger firms as financial information about SMEs is less available and less reliable where the company is not publicly listed.¹⁴⁰

4.2.2 Political and Institutional Risks

Political and institutional risks are very closely tied to macroeconomic risks, the difference being the extent to which companies and management can actually have influence.¹⁴¹ Political/policy and institutional risks encompass those risks which may be rooted in macroeconomic occurrences, but which affect the company through certain political or legal decisions based on the occurrence.¹⁴² Risks in this category affecting SMEs include:

- Government policy regarding funding decisions or lack of decisions prolong the decision making process whereby it often results in no decision being made at all;¹⁴³
- Governmental, institutional and organizational criticism regarding equal treatment as well as fundamental rights and non-discrimination

¹³⁷ Ibid. Bartlett, p. 244

¹³⁸ Ibid. Oxelheim, p. 27

¹³⁹ EU SME Union in Brussels, represents the interests of SMEs within all the participating Member States

¹⁴⁰ Thornhill, Stewart, et al. *Growth history, knowledge intensity and capital structure in small firms*, Venture Capital, January 2004, Vol 6, No. 1, p. 75

¹⁴¹ Ibid. Bartlett, p. 244

¹⁴² Ibid. Bartlett, p. 244

¹⁴³ According to Greg Batcheller, the “Swedish capital market for high-tech start-ups is somewhat underdeveloped and those who provide this kind of funding are not especially good at deciding which companies to fund”, April 15, 2005

principles¹⁴⁴ for the special treatment of SMEs may prevent certain positive developments being made in favour of SMEs including HST;

- Each Member State currently has its own view, rules and laws concerning cross-border business operations which pose enormous financial pressure, (double) taxation complications and cross-border profit/loss transfer complications on companies operating abroad¹⁴⁵, especially SMEs;¹⁴⁶
- Member State Governments are often unwilling to improve communication or exchange information, making cross-border expansion more difficult to establish;¹⁴⁷
- EU case law regarding thin capitalization rules has influenced Member State governments to become more protective of their sovereignty regarding taxation.¹⁴⁸ This encourages the discrimination which has occurred between resident and non-resident companies and between SMEs and larger companies.¹⁴⁹

4.2.3 Competitive Risks

Competitive risks arise from the uncertainty of how competitors will respond to a company's strategy. According to Bartlett and Ghoshal, perfect competition and pure monopoly rarely exist, which results in most companies facing some type of competitive risk.¹⁵⁰ SMEs face competitive risks including:

- Difficult to convey quality in product in order to gain competitive advantage through differentiation compared to large firms that have a quality product and economies of scale;¹⁵¹

¹⁴⁴ Ibid. Deloitte EU Tax Group; reference to Art 12 EC and Art 14 ECHR

¹⁴⁵ Lodin S.O. and M. Gammie, *Home State Taxation*, IBFD Publications BV 2001, p. 13

¹⁴⁶ Ibid. EU Commission Communication COM(2004) 70 final, p. 14

¹⁴⁷ Ibid. Lodin p. 15

¹⁴⁸ Brosens, Linda *Thin Capitalization rules and EU law*, EC Tax Review 2004/4, p. 192, 202

¹⁴⁹ Ibid. Brosens, p. 192, 202; Ibid. Deloitte EU Tax Group

¹⁵⁰ Ibid. Bartlett, p. 244

¹⁵¹ Ibid. Berger, p. 616

- Competitor SMEs are older and have therefore gained more valuable knowledge and resources thus creating a competitive advantage over younger SMEs;¹⁵²
- Competitor SMEs possibly have more international management resulting in greater knowledge of operations in foreign markets. They also have foreign strategic partnerships which create further competitive advantages;¹⁵³
- Different corporate tax levels which could create a competitive advantage for SMEs in other Member States.¹⁵⁴

4.2.4 Resource Risks

Resources can include any internal resource ranging from knowledgeable personnel to capital which could hinder flexibility which in turn hinders cross-border activity. These risks overlap with competitive risks as well.¹⁵⁵

Resource risks for SMEs include:

- Hard to obtain medium-sized financing; it is usually easier to acquire a large amount of financing than a smaller amount;¹⁵⁶
- A financing gap for companies of this size which can be explained by the high risk¹⁵⁷ and PD;¹⁵⁸
- Lack of key human resources due to lack of funding;¹⁵⁹

¹⁵² Reuber, A. Rebecca, Eileen Fischer *The Influence of the Management Team's International Experience on the Internationalization behaviour of SMEs*, Journal of International Business Studies, Vol 28, No. 4, p. 807

¹⁵³ Ibid. Reuber, p. 811

¹⁵⁴ For example, the corporate tax rate in Germany is 38.3% compared to 12.5% in Ireland (Source: Eurostat http://epp.eurostat.ec.eu.int/cache/ITY_PUBLIC/2-01072004-BP/EN/2-01072004-BP-EN.HTML March 31 2005); see Appendix 1

¹⁵⁵ Ibid. Bartlett, p. 244

¹⁵⁶ Greg Batcheller, DuoCort AB "in the Swedish market, like others in Norden and elsewhere favours companies that have developed further and who need more money. It is far easier to raise 30, 50 MSEK or more than it is to raise 3, 5 or 10 MSEK. There is a gap and it is not being adequately filled" April 15, 2005; also referring to Ibid. Berger, p. 623, in terms of company size and the level of information transparency which is prevalent in larger sized SMEs which renders financing more accessible (Ibid. Berger, p. 626).

¹⁵⁷ Ibid. Andersson p. 2

¹⁵⁸ Ibid. Dietsch, p. 779

¹⁵⁹ Greg Batcheller, DuoCort AB, Interview March 2004

- Language difficulties in understanding and communicating with authorities, customs and other institutions in another Member State which poses further barriers to successfully expanding cross-border.¹⁶⁰

4.3 Current SME Situation Conclusion

The SME situation in this chapter is precisely what the Commission report¹⁶¹ also found. SMEs face particular challenges mostly due to their small size. Cross-border operations will invariably incur costs for a company. Due to the small size and limited financing, these costs are comparatively higher for the SMEs than for larger publicly traded companies. Furthermore, there is an information asymmetry between SMEs and larger companies in that they are not publicly traded. SMEs are not as transparent or comparable to potential investors. This information asymmetry impedes the SMEs' access to financing as it increases the cost of capital.

Macroeconomic factors influence the corporate world as a whole, but again, because of the small SME size, the effects of unexpected macroeconomic changes could be much more devastating to SMEs than to larger and more financially stable companies. The political and institutional factors affect SMEs because the SME community is considered by some as receiving 'special treatment'¹⁶² but also because any legal or political decision which affects large and small companies alike will likely burden SMEs more in relative terms.

However, the small size of SMEs does not only carry weaknesses and threats. It is also considered positive as it has different internal strengths and external opportunities which are specific and different to larger companies

¹⁶⁰ Ibid. EU Commission Communication COM(2004) 70 final, p. 14

¹⁶¹ Ibid. EU Commission *Summary Report*

¹⁶² Reference to part 2.6.2(e) above concerning the discrimination some literature (in Chapter 2) points to of larger companies by SMEs due to different rules and exemptions based on company size

precisely due its small size. The knowledge and product differentiation as well as employee motivation prevalent in the SMEs are great opportunities of which only the small-sized companies can take advantage. However, the access to financing, related information asymmetry and cross-border taxation issues seem to be the backbone of most of the weaknesses, threats and risks that SMEs face which are hindering cross-border economic activity.¹⁶³

¹⁶³ Ibid. EU Commission Communication COM(2004) 70 final, p. 4, 16

5 EC Tax Law and HST

As shown in the previous chapter, cross-border expansion and SME growth are particularly challenged by financing and tax related issues. This section will consider the following two guideline questions: What is HST and why this reform has been proposed? And how are the principles of HST aligned with or divergent from EC case law and the current direct taxation developments within the EU? This chapter will present the developments of tax harmonization and discuss whether EC tax law and HST take the SME cross-border issues into consideration in order to decrease the current cross-border hindrances.

5.1 EC Tax Law Background

The legal principles and harmonization issues surrounding taxation in the EU will briefly be mentioned to provide a general understanding of the current taxation and harmonization situation in the EU.

EC Law is based first and foremost on the EC Treaty.¹⁶⁴ The goal of the Treaty is to establish a common market and working towards a “harmonious, balanced and sustainable development of economic activities [...] a high degree of competitiveness and convergence of economic performance [...] raising the standard of living and quality of life, and economic and social cohesion and solidarity among Member States”¹⁶⁵. One of the ways in which this goal is aimed to be fulfilled is through the “approximation of the laws of Member States to the extent required for the functioning of the common market”¹⁶⁶; that is to say the harmonization of laws to the extent necessary.

¹⁶⁴ Treaty establishing the European Community, December 2002

¹⁶⁵ Article 2, EC Treaty

¹⁶⁶ Article 3, EC Treaty

Where harmonization is lacking or not yet been achieved,¹⁶⁷ mutual recognition is relied upon. Mutual recognition involves the acceptance of each Member State's rules and regulations by other Member States. The mutual recognition principle as stated in the *Cassis de Dijon* case has been used by the ECJ in a multitude of cases including tax law.¹⁶⁸

Tax law cases fall under one or more of the four fundamental freedoms granted by several articles in the EC Treaty. These articles include freedom of movement of Goods (Article 28), freedom to provide Services (Article 49 and workers Article 39), freedom of Establishment (Article 43 and 48), and the freedom of movement of capital (Article 56). Tax law issues have been tried under Article 39, 43, 49 and 56 with regards to cross-border operations or activities by either private or legal persons ranging from SMEs to multinational companies. Any decision the European Court of Justice (ECJ) makes affects SMEs like the multinational companies, as shown in Chapter 2.6 and 2.7. By explaining the current EC tax issues and analyzing ECJ court cases, it will help us understand the workings of HST from a legal perspective. Furthermore this will allow us to understand some of the repercussions tax law and relevant case law have on companies in general, SMEs (in terms of cost) in particular, and what HST means legally and practically for SMEs.

5.1.1 Harmonization Issues

Harmonizing taxes will essentially pursue the objectives of the EC Treaty as a whole. Harmonization of taxes will touch upon the four freedoms as well as competition within the EU. The objective of tax harmonization is to

¹⁶⁷ Case C-270/83 *Commission v. French Republic* (avoir fiscal), §22

¹⁶⁸ Referring to Case C-120/78 *Rewe-Zentrale AG v. Bundesmonopolverwaltung für Branntwein* (*Cassis de Dijon*). This case falls under the freedom of movement of Goods; *Cassis* was not allowed to be imported from France into Germany because of different alcohol content rules; the ECJ ruled that if *Cassis* had been produced and sold legally in one Member State (France) that it was allowed to be sold in another Member State (Germany); Tax cases decided based on mutual recognition includes *Centros* and *Futura* (See Chapter 5.4.2 and 5.4.3)

“eliminate fiscal obstacles to economic integration”¹⁶⁹ and to be” capable of sustainable economic growth with more and better jobs and greater social cohesion”¹⁷⁰; this is directly related to the goal of the *European Agenda for Entrepreneurship* and thus affects the current SME situation.¹⁷¹

Harmonizing direct taxes enables businesses to operate freely and to raise capital throughout the EU.¹⁷² A balance must be found between enabling the free movement principles of the EC, while ending “flows of trade and capital which exist only because of tax disparities”¹⁷³. Therefore, tax harmonization can be considered as an ultimate goal in the development of tax law within the EU. However, as the obstacles surrounding the harmonization of direct taxes penetrate into the political, social and fiscal policies of each Member State,¹⁷⁴ there is ongoing tension between the power of Member States to tax and the freedoms granted by EC law to all EU nationals.¹⁷⁵ Harmonizing direct taxes will be a lengthy economic integration process;¹⁷⁶ it carries political risks and could thus carry with it significant financial consequences of implementation both for the Member State and the individual company.¹⁷⁷ A Commission SME questionnaire found that an alternative tax regime such as HST was considered welcome by a third of the participating SMEs.¹⁷⁸

5.1.2 Economic integration Obstacles

According to Farmer the harmonization issues of direct taxes include a distortion of cross-border investment decisions due to differing post-tax

¹⁶⁹ Farmer, Paul & Richard, Lyal, *EC Tax Law*, Clarendon Press: Oxford 1994 p. 8

¹⁷⁰ Ibid. Lodin, p. 9

¹⁷¹ Ibid. EU Commission *Summary Report TAXUD E.1/DOC (05)2301*, p. 4; and as considered in Chapter 2

¹⁷² Ibid. Farmer, p. 10

¹⁷³ Ibid. Farmer, p. 8

¹⁷⁴ Ibid. Farmer, p. 10;

¹⁷⁵ Opinion of Advocate General Poiares Maduro on Case C-446/03, 7 April 2005, §6

¹⁷⁶ Doerr, Ingmar *A Step Forward in the Field of European Corporate Taxation and Cross-border Loss Relief: Some comments on the Marks and Spencer Case Intertax*, Vol 32, Issue 4, p. 186

¹⁷⁷ Referring to the Political, institutional and legal risks of Chapter 2.6 and 2.7

¹⁷⁸ EU Commission *Summary Report TAXUD E.1/DOC (05)2301*, p. 4

Return on Investment and double-taxation of profits. There is also a non-extension of tax relief to cross-border operations and the taxation of foreign income that may have already been taxed in the Member State where the income was incurred.¹⁷⁹ Essentially this implies that the lack of tax harmonization leads more often than not, to double-taxation and no compensation for losses made abroad.¹⁸⁰

The creation of the Economic and Monetary Union (EMU) in 1973¹⁸¹, and the common currency – Euro – in 1999 have made integration improvements. It is considered that since other integration obstacles such as currency and trade barriers have been resolved, tax harmonization has risen to the surface as a single-market obstacle still remaining.¹⁸²

5.1.3 Tax Law

Taxes are usually based on the criteria of residence and source, whereby individuals and companies are taxed according to the established residence and the country of income source. Due to the lack of tax harmonization, there are various combinations of the two criteria where double taxation consequently arises.¹⁸³

There are two ways in which double taxation is addressed; the credit and exemption method of relief.¹⁸⁴ Through the credit method, foreign income is still taxed, however, there is some relief provided by compensating the foreign paid tax against the domestic tax payment due. The exemption method of relief simply exempts any foreign income from being taxed domestically.¹⁸⁵

¹⁷⁹ Ibid. Farmer, p. 10

¹⁸⁰ Ibid. Doerr, p. 185

¹⁸¹ Ibid. Farmer, p. 22

¹⁸² Craig, Adam (Deloitte London) *Corporate Tax Harmonization moves up the EU agenda* International Tax Review, London: Oct 2004

¹⁸³ Ibid. Farmer, p. 248

¹⁸⁴ Ibid. Farmer, p. 248

¹⁸⁵ Ibid. Farmer, p. 249

Often tax systems, under a ‘classical’ taxation method (taxation based on a combination of residence and source), do not consider the issue of double taxation. Double taxation arises because of cross-border transactions, or for example, when dividends are taxed once to the company and once again to the shareholder. According to Farmer, financing decisions can become distorted under the classical system of taxation. To counter the double taxation of dividends, the so-called ‘imputation system’ has been implemented in some countries, whereby shareholders are provided with a tax credit against their personal income tax liability for the amount of corporation tax that has already been paid on the dividends.¹⁸⁶

5.2 Other Taxation Issues

There are currently 25 different tax regimes (in 19 different languages) which have their own requirements, administrations and laws concerning the conduction of business in the respective Member States; including the calculation of income tax, withholding tax, and dividend tax.¹⁸⁷ This is especially “taxing” for SMEs where their financial situation already places them at a comparative disadvantage to larger firms where both capital and assets are more tangible and thus are more reliable collateral.¹⁸⁸

As shown in Chapter 4, companies who expand into other Member States are often burdened by double taxation where losses in one country cannot be set off by profits in another country¹⁸⁹ and the transfer pricing risks when crossing border is increased due to different tax laws and administrations.¹⁹⁰

¹⁸⁶ Ibid. Farmer, p. 250

¹⁸⁷ Ibid. EU Commission Communication COM(2004) 70 final, p. 16

¹⁸⁸ Surina, Jesús, Carlos Trucharte *The Impact of Basel II on Lending to Small- and Medium-Sized Firms* Journal of Financial Services Research 26:2 p. 122

¹⁸⁹ Lodin, Sven-Olof & Gammie *Home State Taxation Exerpt*, 2001, p 3; also referring to AMID C-141/99 – where the parent company was not able to set off its losses by its profits in a branch located in another Member State, judgement was in favour of the parent company, therefore allowed to offset losses in home member state by profits of a branch in other member state.

¹⁹⁰ referring to Lankhorst-Hohorst Case C-324/00 – question of parent company granting its subsidiary a ‘loan’ with accompanying ‘comfort letter’; loan repayable only if payment of

Companies may find it difficult to expand cross-border without accumulating further tax burdens.¹⁹¹

5.3 Home State Taxation

The HST scheme proposed will involve the mutual recognition of all Member States national taxation methods using an apportioned formula to divide the profits.¹⁹² This agreement between Member States is voluntary, and requires only that tax regimes are 'similar'. It is considered that HST will save each SME the headache of attempting to satisfy different national taxation schemes of Member States where their company is operating. This will reduce double-taxation and increase efficiency and savings for the company. It will also be an incentive for small companies currently operating in one Member State to grow and expand into other Member States.

5.3.1 The Basics of HST

The fundamental components of HST address the information and compliance issues, the double-taxation and profit-loss set off issues and transfer pricing. These components include:

- Member States with similar taxation systems will agree to mutually recognize each other's system to calculate and consolidate profits of groups of companies operating in their Member States;¹⁹³
- Companies operating in participating Member States will use the taxation system of the Member State of permanent establishment or

debts not required to a subsidiary by a third-party creditors; judgement in favour of Lankhorst-Hohorst parent company. See Chapter 3.5.4 for detailed discussion of this case.

¹⁹¹ Ibid. EU Commission Communication COM(2004) 70 final, p. 16

¹⁹² Ibid. EU Commission Communication COM(2004) 70 final, p. 16

¹⁹³ Lodin S.O. and M. Gammie, *Home State Taxation*, IBFD Publications BV 2001, p. 21

Home State. The tax base for the company or group of companies will use a single tax system to calculate profits and therefore tax;¹⁹⁴

- The participating Member States will use a specified formula to share the tax base. Therefore each Member state can apply its own corporate taxation rate to the part of profits allocated to activities in its territory.¹⁹⁵

According to Lodin and Gammie, the fundamental components of HST will:

- Resolve cross-border tax obstacles including the transfer of profits-losses between the parent company in its home state and its subsidiaries abroad because they will be consolidated under one set of corporate taxation rules;¹⁹⁶
- Be voluntary both for Member States and for companies to adopt;
- Not require the harmonization of tax accounting rules;¹⁹⁷
- Adopt existing tax systems therefore avoiding any problems of adjustment towards the new system;¹⁹⁸
- Require more cooperation between tax authorities in different Member States¹⁹⁹ making it easier for SMEs to expand abroad;²⁰⁰
- Limit the differences in taxable income between Member States because the system is based on mutual recognition of income calculation rules;
- Not increase tax authority workload because the system is based on self-assessment;²⁰¹
- Not be limited to company size;²⁰²
- Eliminate transfer pricing issues because they will be neutralized by the computation and consolidation of profits;²⁰³
- Render Thin capitalization rules which are currently a burden, less significant under HST;²⁰⁴

¹⁹⁴ Ibid. Lodin, p. 16

¹⁹⁵ Ibid. Lodin, p. 14

¹⁹⁶ Ibid. Lodin, p. 16

¹⁹⁷ Ibid. Lodin, p. 16

¹⁹⁸ Ibid. Lodin, p. 18

¹⁹⁹ Ibid. Lodin, p. 18

²⁰⁰ Ibid. Lodin, p. 17

²⁰¹ Ibid. Lodin, p. 19

²⁰² Ibid. Lodin, p. 16

²⁰³ Ibid. Lodin, p. 19

- Not place tax costs on existing companies transitioning into the HST system.²⁰⁵

Appendix 2 shows the illustration is provided in order to explain the basics of HST in the Commission’s Consultation Paper²⁰⁶ on the application of HST to SMEs.

5.3.2 HST Issues

HST does have some requirement issues that could pose difficulties in implementation. These include:

- Member States having to agree on a satisfactory formula to divide profits between the Home State and others where the company is operating;²⁰⁷
- HST does not require participation of every Member State, however it does require that there is sufficient participation to make the system worthwhile;²⁰⁸
- Agreements on guidelines of company-types and activities that qualify for, or are to be excluded from, the HST system;²⁰⁹
- Agreements of administrative cooperation;²¹⁰
- HST may require that some Member States readjust the existing domestic corporate tax system so that it can be mutually recognized by other Member States;²¹¹
- The profit sharing between Member States may reduce the taxable profits available for sharing as the losses and revenues are consolidated;²¹²

²⁰⁴ Ibid. Lodin, p. 29

²⁰⁵ Ibid. Lodin, p. 19

²⁰⁶ EU Commission Consultation Paper *The experimental application of “Home State Taxation” to small and medium-sized enterprises in the EU* TAXUD/C/1 DOC 2110, January 2003, p. 6

²⁰⁷ Ibid. Lodin, p. 20

²⁰⁸ See Appendix 1

²⁰⁹ Ibid. Lodin, p. 45

²¹⁰ Ibid. Lodin, p. 18; and in reference to EC Directive 77/799 concerning mutual assistance by the authorities of the Member States in the field of direct and indirect taxation, 19 December 1977.

²¹¹ Ibid. Lodin, p. 24

- A company cannot change its Home State without reason;²¹³
- The requirement that the Home State should be considered one to which the company has a genuine relationship. This means Member States can choose not to recognize ‘brass plate’ or ‘mailbox’ companies under the HST system.²¹⁴

5.4 Case Law

EC Case law continues to be in development, and each new case moves the goals of the EC Treaty forward. Under Article 43²¹⁵ and 48²¹⁶ concerning the freedom of establishment there are several landmark or recent cases which will help us understand the issues surrounding EC company taxation. The following cases which fall under one of the four Articles 39, 43, 49 or 56, have been chosen to illustrate the current difficulty in harmonizing direct taxes in the EU. Furthermore, the taxation developments through case law will help us determine the positive and negative legal issues which HST calls forth when compared to the case law and the goals of the EC Treaty. This determination is essential for us to understand how HST will affect SMEs from a legal and financial standpoint.

In the Deloitte Report on potential competition and discrimination issues related to EU tax consolidation, it lists arguments which have been used in tax related cases and rejected by the ECJ. These arguments relate not only to the cases to be presented in the following section, but also to the HST principles proposed to reduce the cross-border issues involving transfer costs, thin capitalization and foreign transfer of losses. Furthermore, every

²¹² Ibid. Lodin, p.33

²¹³ Ibid. Lodin, p. 44

²¹⁴ Ibid. Lodin, p. 44

²¹⁵ “Right to take up and pursue activities as a self-employed person and to set up and manage undertakings...under the conditions laid down for its own nationals ...”

²¹⁶ Right for “companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or place of principal business within the Community are to be treated the same way as natural persons who are nationals of Member States”

case which reaches the ECJ affects how companies (or groups of companies) established within the EU can legally operate cross-border; this includes SMEs as the legal and political decisions made often increase the SME's costs and possibly influence other '4 risk' factors discussed in Chapter 4.2.1 and 4.2.2. These arguments include:²¹⁷

- Absence of tax harmonization;
- Influence of double taxation conventions;
- Effectiveness of fiscal supervision;
- Protection of tax base and social welfare;
- Availability of alternative structure;
- Counterbalance of disadvantage by other advantages;
- Prevention of abuse;
- Low taxation in another Member State;
- Cohesion of the tax system.²¹⁸

5.4.1 Avoir Fiscal C- 270/83²¹⁹

"The *Avoir Fiscal* case was the first direct-taxation case ever to reach the Court".²²⁰ The case concerned the requirements for a French tax credit based on the place of establishment of an agency or branch. This credit was aimed to avoid double taxation. The French law did not allow agencies or branches without a permanent establishment in France or without a double tax convention (DTC) with France to receive this credit. In this case, French branches of a German insurance company were denied this credit. The ECJ ruled that this requirement was discriminatory and none of the arguments on behalf of France were justified under Article 43 of the EC Treaty.

²¹⁷ Ibid. Deloitte EU Tax Group, p. 19; in reference to Commission v. France C-270/83, Bachmann C-204/90, Danner C-136/00

²¹⁸ This was accepted in the case of Bachmann and partly in Futura C-250/95.

²¹⁹ Case C-270/83 Commission v. French Republic (avoir fiscal)

²²⁰ Wattel, Peter and Ben Terra *European Tax Law* p. 78

Although none of the seven arguments²²¹ put forward for justification in this case were accepted by the ECJ, both the arguments used and the subsequent decision laid the foundation for other direct taxation law cases to follow.²²² However, HST will not treat resident and non-resident SMEs equally as each company will be taxed according to the rules of its Home State. Therefore, while an SME operating cross-border will be treated the same as SMEs in its Home State, it will be treated differently from SMEs in the Member State in which it is operating. This could pose discrimination issues.²²³

5.4.2 Centros C-212/97²²⁴

The (mailbox) company Centros Ltd was established in the UK by a Danish couple. This couple then attempted to establish a branch in Denmark, which was refused by the Danish trade department based on the argument that they only wanted to establish a branch in order to circumvent national rules. The ECJ found that it was contrary to Articles 43 and 48 to refuse the establishment of the branch and it was not a proportional measure to prevent fraud. The result of this case indicates that exercising the freedom of establishment does not automatically signify tax evasion or abuse.

It is considered that tax evasion or abuse (called ‘double dip abuse’) is much less of an issue than being double-taxed in cross-border operations.²²⁵ This

²²¹ 1. lack of harmonization, 2. issue can only be resolved through DTC, 3. danger of tax avoidance, 4. financial advantages outweigh other disadvantages, 5. distinguishing between resident and non-resident companies occurs in every tax regime, 6. one can set up a subsidiary instead, 7. there is a discrimination against other sectors other than insurance

²²² Ibid. Wattel, p. 84-94; including Futura, and Bosal cases

²²³ EU Commission Consultation Paper *The experimental application of “Home State Taxation” to small and medium-sized enterprises in the EU* TAXUD/C/1 DOC 2110, January 2003, p. 11 and <http://www.fondazioneelucapacioli.it/download/FINHOMES.PDF> *Summary Report on the outcome of the TAXUD Consultation of interested parties on The experimental application of “Home State Taxation” to small and medium-sized enterprises in the EU [February - June 2003]*. p. 4-5; many consulted on the implementation of HST “acknowledge that there is at least a risk of discriminations [...] concerning companies in the same State applying different rules because they have different Home States”

²²⁴ Case C-212/97 *Centros Ltd v. Erhvervs – og Selskabsstyrelsen*

²²⁵ Ibid. Doerr, p. 185; ‘double dip abuse’ means that a private or legal person is over compensated for cross-border taxation and thus does not pay the full amount of tax he/it should.

case illustrates the extent to which the freedom of establishment overrides national rules regarding cross-border economic activities. However, ‘mailbox’ is not defined in this case, which signifies that ‘mailbox’ or ‘brass plate’ company as referred to in the HST principles may not fall under the equivalent category.²²⁶

5.4.3 Futura C-250/95²²⁷

Futura was a company with its principle seat in France with a branch, Singer, in Luxembourg. A double-tax agreement between the two countries allowed each Member State to tax the income made in its territory; that is, taxation of source income. Futura was refused to set off its five year losses against its current year income due to specific Luxembourg conditions. The first condition²²⁸ was accepted by the ECJ as being proportional and justified under Article 43 and 48. However, the second condition²²⁹ was not justified by the ECJ and not considered essential or proportional. Furthermore, the ECJ and the Advocate General made reference to the Directive 77/799 on mutual assistance to aid both authorities to obtain information needed in cross-border operations.

Hatzopoulos considered that this case sheds light on the issues surrounding direct taxation and the importance of realizing Treaty objectives although the core EC law issues regarding the freedom of movement was in no way clarified through this case.²³⁰ This case illustrates two issues; firstly the transfer of foreign loss issues that arise where mutual recognition and mutual assistance does not prevail,²³¹ and secondly the fact that Member

²²⁶ Referring to Chapter 3.4.2(h)

²²⁷ Case C-250/95 Futura Participations SA and Singer v. Administration des Contributions Luxembourg

²²⁸ To deduct losses from previous years, that the loss must be economically related to income received locally

²²⁹ To keep ‘proper accounts’ under Luxembourg requirements

²³⁰ Hatzopoulos, Vassilis, *Case C-250/95, Futura Participations SA & Singer v. Administration des Contributions (Luxembourg), Judgment of 15 May 1997, [1997] ECR I-2471* Common Market Law Review 1998, Volume 35, Issue 2, p. 493-518

²³¹ Ibid. Lodin, p. 18, 21. Both mutual recognition and mutual assistance are underlying workings of HST

States define secondary establishment differently. Both these issues, the transferring a foreign loss and acknowledging secondary establishments through mutual recognition will be decreased with the implementation of HST, thus lightening current burdens for SMEs expanding cross-border.²³²

5.4.4 Lankhorst-Hohorst C-324/00²³³

The case concerned Lankhorst-Hohorst (LH), a limited liability company established in Germany, with its parent Lankhorst-Hohorst BV (LH BV) established in the Netherlands. LH BV granted LH a loan which was only repayable if LH did not have other loan payments due. This was considered unacceptable under German law for two reasons. The German authorities did not consider this a loan but a redistribution of profits, and therefore taxed the loan as capital. Furthermore it was considered that a third party creditor would not have granted the loan under similar circumstances due to the amount of debt LH had already acquired. This was therefore contrary to German thin capitalization rules. The ECJ found that loss of revenue (referring to the thin capitalization rules) was not a justifiable argument and that the German company with foreign owned subsidiaries was being treated less favourably than a domestic German company in the same situation. This was therefore discriminatory and contrary to EC law.

This case illustrates both transfer pricing and thin capitalization issues which Lodin states will be reduced or eliminated with HST.²³⁴ Körner considers that “this judgment is not confined to the area of thin capitalization. The ECJ [...] made several statements as regards the possibilities of a justification of a restriction on the fundamental freedoms which are of general importance. [...] These statements underpin the general

²³² Ibid. Lodin, p. 19

²³³ Case C-324/00 Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt

²³⁴ Ibid. Lodin, p. 19, 29

incompatibility of [...] transfer pricing provision [...] with European law.”²³⁵

In the Article *Thin Capitalization rules and EU law*, different Member State countries are considered concerning the extent of discrimination in their thin capitalization rules. Many Member States’ rules are possibly discriminatory based on nationality and depending on the implementation of the rules.²³⁶ For example, the German and Danish thin capitalization rules are considered to be similar; “in both countries there is discrimination against foreign parent companies...rules on thin capitalization...take effect against (parent) companies based abroad”²³⁷. In order to realign national rules after the *Lankhorst* case, Vinther et al. considered that both extremes are unacceptable as it would either lead to more easily achievable tax avoidance or create further administrative burdens.²³⁸ Since the *Lankhorst* case, some Member States have indeed reacted within the two extremes; either applied their thin capitalization rules to domestic companies as well or changed the thin capitalization ratio, instead of abolishing the discriminatory rules.²³⁹ The Member States’ reactions to *Lankhorst* illustrates the political and legal risks affecting SMEs as discussed in Chapter 4.2.2 and 4.3.

5.4.5 Bosal C-168/01²⁴⁰

This case concerns the transfer of foreign subsidiary costs to the parent company. A Dutch-established company with several foreign subsidiaries attempted to transfer costs of its subsidiaries against its Dutch-taxable income. The Dutch authorities did not allow this unless the costs were

²³⁵ Körner, Andreas *The ECJ’s Lankhorst-Hohorst Judgement – Incompatibility of Thin Capitalization Rules with European Law and Further Consequences* Intertax Vol. 31 No. 4, 2003

²³⁶ Ibid. Brosens, p. 198-202

²³⁷ Vinther, Nikolaj et al. *The need for fresh thinking about tax rules on thin capitalization: the consequences of the judgment of the ECJ in Lankhorst-Hohorst* EC Tax Review 2003/2, p. 103

²³⁸ Ibid. Vinther, p. 105

²³⁹ Ibid. Brosens, Linda, p. 198-201; Denmark adopted thin cap rules to apply to resident as non-resident companies, Germany changed its thin cap ratio from 3-1 to 1.5-1 and Spain chose to abolish them.

²⁴⁰ Case C-168/01 *Bosal Holding BV v. Staatssecretaris van Financiën*

indirectly instrumental to making profits in the Netherlands. Therefore, the problem involved the costs not being deductible anywhere. The ECJ reasoned that this law was discriminatory against Dutch companies with foreign subsidiaries compared to a Dutch company with Dutch subsidiaries. It was therefore ruled that Article 43 precludes national law requiring costs to be indirectly instrumental to making profits that are taxable in the Member State of the parent company in order to be transferable.

The ruling of the ECJ in the Bosal case is considered to have been one step towards direct tax harmonization in the EU.²⁴¹ This case illustrates that cross-border economic activities and transfer of costs are essential towards the EC goal of a single market. Based on this case, SMEs, like other companies, can transfer costs cross-border where they are in a comparable situation as SMEs operating domestically. This is essential for their sustainable growth.

5.4.6 Marks & Spencer C-446/03²⁴²

The pending *M&S* case has not yet been ruled on by the ECJ. The most recent development is the AG's opinion which was delivered in the beginning of April 2005.

The UK based company Marks and Spencer has foreign subsidiaries in other Member States. The recent years have only shown losses in the foreign subsidiaries. *M&S* in the UK filed for group relief in order to carry over the foreign losses against its domestic income. Under UK law, the group relief can be granted to subsidiaries established in other Member States provided that there is economic activity in the UK. *M&S* was denied group relief, and appealed. The High Court of Justice has applied for a preliminary ruling from the ECJ.

²⁴¹ van den Hurk, Hans, *EU Steps closer to harmonization* International Tax Review 2003, p. 1

²⁴² Case C-446/03 Marks and Spencer vs. David Halsey (HM Inspector of Taxes)

Doerr compares the background of the *Bosal* case to the pending *M&S* case.²⁴³ He comments that the questions posed to the ECJ will have to be reworded if the ECJ is to rule on this pending case and furthermore, that “cross-border relief is a requirement for an internal market without borders and should not fail merely due to the phrasing of questions referred to the ECJ”.²⁴⁴

The AG states that the pending *M&S* case comments on the ongoing tension between the power of Member States to tax and the freedoms granted by EC law to all EU nationals.²⁴⁵ In analyzing the pending case, he refers among others to *Futura*. The AG conclusions are that the Articles 43 and 48 of the EC Treaty preclude the UK rules of prohibiting a company with foreign subsidiaries from gaining group relief. However, the Treaty provisions do not preclude a Member State from disallowing foreign losses from being compensated for where the losses have already been accounted for in that Member State. This pending case demonstrates that transfer of loss issues continue to hinder companies from cross-border economic activities without incurring undue losses. HST will facilitate participating SMEs to avoid incurring losses such as in this case.²⁴⁶

5.4.7 Case Law Conclusion

The case law presented point to some of the specific fundamental principles that will be changed through the implementation of HST.

The *Avoir Fiscal* case concerned the equal treatment of companies who are in the same situation whether they are established in one Member State or

²⁴³ Doerr, Ingmar *A Step Forward in the Field of European Corporate Taxation and Cross-border Loss Relief: Some comments on the Marks and Spencer Case* Intertax, Vol 32, Issue 4, p. 183

²⁴⁴ Ibid. Doerr, p. 185, 186

²⁴⁵ Opinion of Advocate General Poiares Maduro on Case C-446/03, 7 April 2005, §6

²⁴⁶ Ibid. Doerr, p. 185 ”it seems to be a higher risk that M&S will never get compensation for the losses incurred in its investments abroad under current tax law”

another. Furthermore, it emphasized the freedom under Article 43 to choose an establishment; subsidiary, branch or agency. The question arises whether HST will reverse this decision regarding the equal treatment of resident and non-resident companies who are in the same situation for tax purposes. The implementation of HST means that companies in the same situation for tax purposes will not necessarily be treated equally, as non-resident subsidiaries, branches and agencies, which will be taxed according to their Home State taxation requirements instead of those of the host Member State. Therefore, where in *Avoir Fiscal* it concerned the resident companies who had the tax advantage, it could be argued that HST will allow this situation to be reversed,²⁴⁷ and unequal treatment and discrimination will continue.²⁴⁸

The *Centros* case ruling specifically pointed out that the freedom of establishment precludes any Member State from disallowing the establishment of a secondary establishment on the grounds that it is attempting to circumvent national regulations. This includes 'mail box' or 'brass plate' companies. Therefore, the question arises whether a requirement under HST of a genuine relationship for a company to the Home State, and the right of a Member State not to acknowledge a 'mailbox' or 'brass plate' company is contrary to EC case law based on the *Centros* case.²⁴⁹

Contrarily, the *Futura* case strongly supports the mutual assistance directive which is aligned with the HST requirement and expectation that Member States work together by coordinating and communicating sufficient information in order to make cross-border taxation on profits possible.²⁵⁰ Furthermore, the HST principles are aligned with the *Futura* ruling in

²⁴⁷ Non-resident companies could have tax advantages in host Member States where the Home State company taxation rates are lower than those in the Host Member State

²⁴⁸ Ibid. Deloitte EU Tax Group; reference to Art 12 EC and Art 14 ECHR; Ibid. Summary Report on the outcome of the TAXUD Consultation. p. 4-5

²⁴⁹ This question must be considered in the light of the fact that the *Centros* case did not provide a legal definition of 'mail box' company

²⁵⁰ Ibid. Lodin, p. 18

reducing the issue of the transfer or carry forward of a (foreign) loss under the principle of mutual recognition.

The *Lankhorst-Hohorst* case had repercussions in the political and institutional dimension which may or may not be contrary to EC law. However, the reactions of different Member States indicate that the question of direct taxation is an ongoing issue which is not so easily ironed out. It is questionable whether countries such as Germany and Denmark – with protectionist thin capitalization rules - will adopt HST based on their respective reactions to the *Lankhorst* case. This concerns the underlying dichotomy between the power of Member States to tax and the fundamental freedoms awarded by the EC Treaty. This case illustrates why the implementation of HST may be difficult and reflects the political and legal risks discussed in Chapter 4.2.2 and 4.3.

Although the *Bosal* case is considered to have been a step towards direct tax harmonization within the EU, and is seen as having a similar background to the pending *M&S* case, it is evident that direct tax issues are still far from harmonized. The AG's opinion sheds light on what the possible ECJ ruling may be for *M&S*; as Doerr has commented, the ECJ has predominantly ruled in favour of the taxpayer.²⁵¹

In consideration of the case law, the implementation of HST would thus reduce the thin capitalization, transfer pricing and cross-border transfer of loss issues and allow SMEs to incur fewer costs when operating cross-border.

5.5 HST and Case Law Conclusion

Although the HST regime is not confined to a specific company size or industry, the pilot project will only be open to SMEs. Although the

²⁵¹ Ibid. Doerr, p. 186

presented case law did not directly involve SMEs, but companies operating within the EU, the case law decisions affect and will continue to directly affect SMEs in cross-border economic activities.²⁵² The case law presented illustrates some of the EC tax law issues which the HST regime aims to mend.

The positive aspects of HST, including the reduction of thin capitalization issues, transaction costs and cross-border declaration of foreign losses are pressing, especially when one considers some of the case law. HST could pose discrimination issues when considering the *Avoir Fiscal* case as SMEs operating abroad will be treated the same as SMEs operating solely in their Home State while differently from other SMEs in the Member State of operation. Furthermore, HST could pose implementation issues when considering *Lankhorst-Hohorst* as illustrated by Member States being protective of their taxation systems and thin capitalization rules. Despite the progress made through case law to reduce direct taxation issues, it is evident with the pending *M&S* case that direct taxation and harmonization issues remain very real, and that HST is a feasible option in the continuous strive for direct tax harmonization and reduced cross-border burdens for SMEs.

Since the power to implement HST rests upon Member States and not companies, in light of the political issues surrounding mutual recognition and tax apportionment, and its effect on Member States' sovereignty,²⁵³ it is unlikely that HST will be implemented.

²⁵² This includes the political and legal risks mentioned in Chapter 4.2.2 and 4.3 as well as the issues raised in this chapter.

²⁵³ See the *Lankhorst Case*, Chapter 5.4.4 and 5.4.7

6 SMEs and HST Combined

In the previous chapters, the current SME situation and the EC tax harmonization issues have been illustrated, and the HST pilot project described. The current direct taxation within the EU has been considered and relevant case law has been described in relation to HST. Where there is a lack of tax harmonization, the HST regime seems to be a positive alternative. This section will consider the fifth and final guideline question regarding the effects HST will have on SMEs.

6.1 SMEs, HST and SWOT

The SMEs will be analyzed using the SWOT analysis combined with the principles of HST to determine how HST will change the SME situation from a corporate perspective in light of the proposal.

6.1.1 SME Strengths and Weaknesses

The SME strengths and weaknesses are internal to SMEs. Since HST concerns taxation, it will have limited effect on the internal workings of SMEs. Thus, the adoption of HST will do little to change the current internal situation of SMEs. However, it can be considered that employee motivation will increase, and the strive for a comprehensive business plan and strategy will be even more imminent where the opportunities to grow and expand cross-border is made more possible through HST and some of the financing possibilities offered by the EU.

While the inadequate funding, risk level and PD of SMEs remains unchanged, the information asymmetry will be decreased through the implementation of HST as mutual assistance and mutual recognition will facilitate the access to information. Implementing IAS, although carrying

high change-over costs, may be another possibility in increasing transparency and possibilities for funding; all companies can be evaluated equally.

6.1.2 SME Opportunities and Threats

The financing opportunities for SMEs remain unchanged with the implementation of HST. However, HST may make access to financing more tangible since information asymmetry is decreased both through HST, the mutual assistance directive²⁵⁴ and late payment directive²⁵⁵. Furthermore, HST will improve the ease with which a parent company can transfer funds to its (foreign) subsidiaries.

Many of the current taxation-related threats and administrative and legal burdens will be decreased or abolished with the implementation of HST. Although the harmonization of taxes remains at large within the EU, HST will propel the integration of financial services and decrease the administrative and legal burdens. Simultaneously, HST “[complies] with different national tax laws and regulations”²⁵⁶ which eases any cross-border expansion. Furthermore, the double-taxation risks, transfer pricing issues and thin capitalization rules will be decreased with the HST implementation, although it is evident from the case law and Member State reactions to the respective ECJ decisions, that these issues will not be completely abolished even with HST in place. HST will not, however, decrease the threat of liquidation or takeover by a larger company.

6.1.3 SME Model, HST and SWOT Conclusion

The implementation of HST will drastically improve the SME situation. Although some issues still remain, HST evidently is a positive step forward,

²⁵⁴ Council Directive 77/799/EEC concerning mutual assistance by the authorities of the Member States in the field of direct and indirect taxation, 19 December 1977

²⁵⁵ European Parliament and Council directive 2000/35/EC on combating late payment in commercial transactions, 29 June 2000

²⁵⁶ Ibid. EU Commission Communication COM(2004) 70 final, p. 16

both for SMEs in the EU as well as for any company which is operating cross-border within the EU.²⁵⁷ Based on the re-analyzed SWOT, HST will improve the possibility for SME growth and cross-border expansion within the EU.

6.2 HST and the 4 Risks

In order to place the SME situation into a broader context with the application of HST, the 4 environmental risks analysis will be reapplied in order to determine whether the macroeconomic, political, competitive and resource risks will add to or change the affects of HST on the SME situation.

6.2.1 Macroeconomic, Political and Institutional Risks

The macroeconomic risks for SMEs including interest rate changes, exchange rate changes, and wage level changes will not be altered post-HST. Therefore, the cost of capital is still outside the realm of influence by companies. However, the information asymmetries concerning capital market frictions which were found to have a more negative effect on SMEs than larger firms will be decreased with HST as the necessary information will be more transparent through mutual assistance and Member State co-operation.

The political, policy and institutional risks are the most affected by HST. In light of the AG's comment in the *M&S* case, it is evident that the Member States' power to tax carries the risks for SMEs in this category. The funding

²⁵⁷ Seen in the positive reactions from SMEs in the EU Commission *Summary Report on replies received in response to the questionnaire on corporate tax as barrier to EU expansion of SMEs* TAXUD E.1/DOC (05)2301, 18 January 2005, p. 4 and UEAPME Position Paper on the consultation paper from DG TAXUD. March 14, 2003. p. 2-3

decisions or lack of decisions by respective government policies as well as the issues as raised by the *Lankhorst* case indicates that governments will continue to attempt to retain the power to tax. Implementing HST may, both in light of the varying current corporate taxation rates as well as the thin capitalization rules, not be in the individual Member State's interest. Thus, the discrimination between resident and non-resident companies could easily continue. However, implementing HST is in the interest of every Member State being part of a single economic market.

Where each Member State has its own view, rules and laws concerning cross-border business operations, the fact that the Member States have to agree on a formula to divide profits between the Home State and others may pose significant tension between Member States where the individual interest of the State and the interest of the EU may not coincide. However, as stated in Chapter 5.3.1, HST will encourage Member States to further improve communication or exchange information in areas where the mutual assistance directive is already in force.²⁵⁸

6.2.2 Competitive and Resource Risks

The competitive and resource risks will remain predominantly unchanged by HST although the decrease in information asymmetry may alter the competitive playingfield. Although the goal of implementing HST is to increase the financial opportunities for SMEs, the uncertainty of competitors will not be affected by HST. Furthermore, the difficulty in obtaining medium-sized financing will not be improved by HST although the financial programs now available through the EU could ease this risk.

However, difficulties in understanding and communicating with authorities, customs and other institutions in another Member State due to language issues, will be somewhat decreased since the taxation requirements will be

²⁵⁸ Ibid. Lodin, p. 18

settled in the Home State, thus decreasing the administrative burden and costs associated with current cross-border economic activity. The requirement for institutions to exchange information and communicate cross-border will also be eased since minimal paperwork will be required despite cross-border operations and profits.

6.3 HST and 4 Risks Conclusion

It is evident that many of the risks remain unchanged as they cannot be influenced by the company's actions. The political and institutional risks surrounding the actual implementation of the tax reform show that although HST is in the best interest of the EU as a single economic market, its implementation may not be in the best interest of the individual Member State. It is unlikely that Member States will agree on an apportionment formula and hence, HST may be difficult to implement. The financial issues for SMEs as analyzed under the 4 risks are unchanged with the implementation of HST; the risk level, PD and access to funding do not change although the information asymmetry is significantly decreased and there are fewer cross-border costs incurred.

7 Conclusion

The goal of the European Union is to be the most competitive and dynamic knowledge-based economy in the world with sustainable economic growth and social cohesion;²⁵⁹ making it essential that the EU operate as a single market. This goal involves not only the struggle to harmonize areas of the common market including direct taxation, but also to encourage innovation and entrepreneurship. Since SMEs consist of almost 90% of the corporate community, it is essential that this group of companies can integrate and grow. Currently, the SMEs face many hindrances to do this, both due to financial constraints as well as tax issues which make cross-border growth and integration within the European Union difficult. The Home State Taxation reform was therefore proposed by the Commission for two reasons. Firstly, it will decrease the administrative and legal burdens which SMEs currently face, and secondly it will draw on the principle of mutual recognition as an attempt to become one step closer to tax harmonization within the European Union.

The struggle to harmonize areas of the common market has involved many small steps. European Union case law, Commission Directives as well as proposals such as the Home State Taxation reform all contribute to facilitating the aspiration for harmonization.

While aspiring to harmonize, the actual implementation of Home State Taxation poses some discrimination and implementation issues. Significant criticism has been voiced concerning fundamental rights, and the principles of equal treatment and non-discrimination. Despite the progress made towards harmonization, it remains far from being achieved. This again explains why Home State Taxation was proposed as an alternative, as it draws on the principle of mutual recognition. Where harmonization is not possible, mutual recognition can, to the extent possible, facilitate the

²⁵⁹ Lisbon European Council *Bulletin of the European Communities* No. 6/1992

continuation and further development of efficient economic activity as a single market.

Based on mutual recognition, Home State Taxation can decrease the current cross-border issues without requiring Member States to completely alter taxation levels or completely renounce their sovereignty. This can encourage Member States to both work together in the common interest of the European Union as a single market while simultaneously acting in the interest of each Member State. Transfer pricing, thin capitalization, transfer of losses and double taxation will therefore become less of an issue through Home State Taxation.

The implementation of HST will work in favour of SMEs as it will decrease the hindrances and costs associated with the information asymmetry, legal and administrative burdens and financing constraints posed by the existence of 25 different regimes. However, since HST is based on formula apportionment, it is unlikely that Member States will agree to implement this tax regime. Furthermore, contrary to what is stated in the Commission's Agenda for Entrepreneurship, this proposed tax regime will not directly improve the accessibility of financing to SMEs, although, it will render cross-border activity less costly.

The fact remains that financing for start-up (micro-sized), and medium-sized SMEs is relatively accessible, something which has become apparent in writing this thesis. Therefore, the issue is not only cross-border taxation issues or making financing for SMEs accessible. Instead it is the financing of small sized SMEs which must be targeted.

In order to improve the financial situation of SMEs, more accessible debt financing must be made possible for small sized SMEs who are between start-up and being financially established.²⁶⁰ As there is a lack of

²⁶⁰ Referring to size of SME seeking short-term and intermediate-term financial loans (Chapter 3.1.3) Ibid. Berger, p. 623

harmonization of direct taxation within the EU, the Home State Taxation proposal is a feasible alternative for companies to the current use of 25 tax regimes. More accessible debt financing combined with the implementation of HST would ensure the smooth integration and sustainable growth of the SME community. However, the dichotomy between Member States wanting to retain the power to tax and the freedom of establishment under the EC Treaty makes the implementation of HST using an apportionment formula less likely. Therefore, in order to ease the burden of cross-border expansion for SMEs the focus ought to be aimed away from tax reforms and towards making debt financing more accessible.

APPENDIX 1

Taxation Rates for EU-15 and EU-25²⁶¹

	Total taxes			Direct taxes		Effective top statutory tax rate on corporate income ⁶ , %
	as % of GDP					
	1995	2001	2002	1995	2002	2004
EU25	40.5	41.1	40.4	31.5	33.1	27.4
EU15	40.6	41.2	40.5	31.5	33.5	31.4
BE	45.1	46.2	46.6	37.9	38.8	34.0
CZ	39.9	34.3	35.4	25.1	26.2	28.0
DK	49.3	49.9	48.9	62.1	60.5	30.0
DE	40.8	40.8	40.2	27.5	27.1	38.3
EE			35.2		24.4	26.0
EL	32.6	37.0	36.2	23.8	26.9	35.0
ES	33.4	35.5	36.2	31.3	31.3	35.0
FR	44.0	45.0	44.2	20.6	27.6	35.4
IE	33.4	30.5	28.6	41.1	40.8	12.5
IT	41.2	42.5	41.7	37.4	34.5	37.3
CY		32.7	32.5		35.8	15.0
LV	37.2	31.8	31.3	23.2	29.9	15.0
LT	28.6	29.1	28.8	30.7	26.2	15.0
LU	42.3	40.7	41.9	41.6	39.3	30.4
HU		39.4	38.8		26.9	17.7
MT	27.7	30.4	31.3	31.4	36.1	35.0
NL	40.6	40.0	39.5	31.2	31.3	34.5
AT	42.3	45.3	44.4	28.4	31.6	34.0
PL	34.3	41.2	39.1	33.2	18.7	19.0
PT	33.6	35.6	36.3	26.6	26.9	27.5
SI	41.3	39.4	39.8	17.5	20.2	25.0
SK	41.5	32.9	33.0	27.9	22.6	19.0
FI	46.0	46.0	45.9	38.2	42.9	29.0
SE	49.5	52.2	50.6	40.8	36.8	28.0
UK	35.4	37.3	35.8	42.6	44.2	30.0

This is in relation to the fact that an apportionment formula must be decided upon, and that ‘sufficient participation’ is required for HST to work. By looking at the national taxation rates, this seems less likely to happen.

²⁶¹ Source: Eurostat http://epp.eurostat.cec.eu.int/cache/ITY_PUBLIC/2-01072004-BP/EN/2-01072004-BP-EN.HTML March 31 2005

APPENDIX 2

Example of how HST would work²⁶²:

1) Profit determination following the rules of Member State A (=home state):					
company Z	income	100	company Y	income	190
	payroll	9		payroll	1
	<u>expenses</u>	41		capital expenditure	
	profit	50		(purchase from Z)	100
				<u>expenses</u>	19
				profit	70
2) Consolidated profits (ie. Combination of all profits of the home state group businesses and elimination of all intra-group transactions):					
profit Z + profit Y =		50+70 =		120	
- transfer price				-100	
+ purchase price				100	
				120	
3) Profit allocation according to payroll formula					
Z:		9/10 * 120 =		108	
Y:		1/10 * 120 =		12	
				120	
4) Taxation of profits					
MS A:		108 * national tax rate			
MS B:		12 * national tax rate			

²⁶² EU Commission Consultation Paper *The experimental application of "Home State Taxation" to small and medium-sized enterprises in the EU* TAXUD/C/1 DOC 2110, January 2003, p. 6

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