Tax Policy Alert

European Commission releases BEFIT, transfer pricing, and head office proposals

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In brief

The European Commission published a new package of proposals on 12 September to put forward (i) a single set of tax rules for doing business in the EU (Council Directive on Business in Europe: Framework to Income Taxation (BEFIT)), (ii) harmonised transfer pricing rules within the EU (Council Directive on Transfer Pricing) and (iii) a Head-Office Tax system for micro, small, and medium-sized enterprises (SMEs) (Council Directive establishing a Head Office Tax system for micro, small, and medium-sized enterprises, and amending Directive 2011/16/EU (the HOT proposal).

The takeaways:

- BEFIT could be a simplification for business, but the introduction of so many new concepts and lack of alignment with the GloBE rules will need to be carefully handled, otherwise it may prove challenging to implement in tandem with other tax reforms.
- A level playing field with respect to transfer pricing is welcomed. But given that the codification of transfer pricing principles is a balancing act between the ambitions of the Commission and the sovereignty of Member States, a mandatory corresponding adjustments system between Member States could improve the proposal.
- While the Head Office Tax proposal for SMEs provides welcome simplifications, it is very narrow in its application and may be of limited practical use. Broader scope would be highly beneficial to crucial growing SMEs in the EU.

All three proposals require a unanimous vote of support from the EU Member States, and this must be achieved before the EU Commission term ends next Spring. Although it is too early to tell whether any or all of these proposals will ultimately be adopted, the TP proposal may find support with many Member States.

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In detail

Business in Europe: Framework for Income Taxation (BEFIT)

BEFIT is the European Commission's proposal which is described as aiming to reduce tax compliance costs for large cross-border businesses in the European Union. According to the Commission, the proposal "will make life easier for both businesses and tax authorities by introducing a new, single set of rules to determine the tax base of groups of companies." The proposal replaces the Commission's CCTB (common corporate tax bases) and CCCTB (common consolidated corporate tax base) proposals. If adopted, Member States would need to implement the BEFIT rules by 1 January 2028 and apply them to BEFIT groups as of 1 July 2028.

The BEFIT rules would apply on a mandatory basis to groups with annual revenues of at least EUR 750 million (i.e., the same revenue threshold as Pillar Two) and their 75% owned subsidiaries (the 'BEFIT group'). For groups headquartered outside the European Union, their EU entities will only be included in a BEFIT group if they totalled at least EUR 50 million of annual combined revenues in the European Union in at least two of the last four fiscal years, or if those entities totalled at least 5% of the total revenues of the group. The rules will be optional for smaller groups, which may choose to opt in as long as they prepare consolidated financial statements. The proposal does not include any sectoral exemptions, but sector-specific characteristics are reflected in the calculation of EU revenues.

Applying the BEFIT rules

1. Computing the tax base at entity level

All members of the same BEFIT group will calculate their tax base using a limited set of tax adjustments to their financial accounting profits or losses. Notably, the adjustments are not fully aligned to the Pillar Two GloBE adjustments. For instance, the exclusion of dividends and gains from the disposition of shares is limited to 95% of the dividends and gains under BEFIT, with no such limitation under GloBE.

2. Aggregating the tax base at the EU group level

The tax bases of the BEFIT group members will be aggregated into one single tax base. The profits and losses of related parties that are not members of the BEFIT group (e.g., because they are not in the European Union) will not be aggregated in the group tax base.

3. Allocating the aggregated tax base

The BEFIT tax base will be allocated to members of the BEFIT group by using a transitional (seven-year) allocation rule. For each fiscal year between 1 July 2028 and 30 June 2035 at the latest, a percentage of the aggregated tax base will be allocated to a BEFIT group member based on the average taxable results in the previous three fiscal years. EU Member States would be allowed to apply additional post-allocation adjustments (i.e., apply their national corporate tax base rules) in areas not covered by the common framework. Pillar Two (domestic) legislation is relevant at this stage, as EU Member States need to ensure that the effective tax rate is at least 15%.

The transitional allocation rule is intended to pave the way for a permanent allocation method that can be based on a formulary apportionment using substantive factors.

4. Facilitating transfer pricing compliance

For transactions with associated enterprises outside the BEFIT group, the proposal aims to simplify compliance with transfer pricing by introducing a common risk assessment tool. Under this 'traffic light system,' based on an interquartile range of a public benchmark (which will be based on a Transactional Net Margin Method approach),

transactions of limited risk distributors and contract manufacturers would fall in a low, medium, or high-risk zone. EU Member State tax administrations would be expected to focus their efforts on the high-risk zone. This common risk assessment does not interfere with the substantive rules that determine whether a certain transaction has been priced at arm's length.

Administration and procedures

A one-stop shop will allow the filing entity (in principle, the ultimate parent entity) to file the group's BEFIT information return with the tax administration of one EU Member State. This administration will share the information with the other Member States in which the group operates. Tax audits and dispute settlements will remain at the level of each Member State.

Transfer Pricing Proposal

The European Commission has also proposed a Directive that aims at harmonising transfer pricing (TP) rules within the European Union and ensuring a common approach to TP problems. The Explanatory Memorandum acknowledges that, while most EU Member States are also OECD Members, the role and status of the OECD TP Guidelines varies across the European Union. Additionally, differences in domestic legislation (e.g., notion of control) creates complexity and the risk of double (non) taxation. Against this backdrop, the Directive proposal would incorporate the arm's length principle and key TP rules into EU law, clarify the role and status of the OECD TP Guidelines and create the possibility of establishing common binding rules on specific aspects of the rules within the European Union.

This Directive would apply to taxpayers that are registered in, or subject to tax in, one or more EU Member States, including permanent establishments (PEs) in one or more EU Member States.

The general rule would be that EU Member States should ensure that, where an enterprise engages in one or more commercial or financial cross-border transactions with an associated enterprise, such enterprise shall determine the amount of its taxable profits in a manner that is consistent with the arm's length principle (as defined in the Directive by reference to the outcome that would have been achieved if the parties were not related, i.e. if the parties were independent of each other and the outcome (price or margins) was determined by (open) market forces). In addition, the Directive provides EU Member States with common rules regarding certain core transfer pricing elements.

An interesting element of the TP proposal is that EU Member States would be obliged to include provisions in the national rules ensuring that the TP rules are applied in a manner consistent with the OECD TP Guidelines. In addition, the Council of the EU may lay down further rules, consistent with the OECD TP Guidelines, on how the arm's length principle and the other provisions laid down in the Directive are to be applied in specific transactions.

The proposed Directive aims to align the EU legislation with Chapters I-III of the OECD TP Guidelines. Further work would likely be needed with respect to intangibles (including hard-to-value-intangibles), services, cost contribution arrangements (CCAs), financial transactions, business restructurings and dealings between head offices and PEs.

Under the terms of the proposed Directive, EU Member States should implement the TP rules by 1 January 2026.

Observations

- The ambitions of the Commission, and the sovereignty of Member States may require delicate negotiation when it comes to codification of the arm's length principle as well as key TP principles (such as the notion of 'associated enterprise,' fast track dispute resolution, corresponding and compensating adjustments).
- In that regard, the proposal stresses the gradual expansion of the commitment towards common approaches, starting with less contentious topics, e.g., documentation-related initiatives. This offers the

opportunity for early engagement on matters such as streamlined benchmarks with and among Member States.

- Interestingly, the envisaged entry into force is 1 January 2026 for the TP Directive, but 1 January 2028 for BEFIT.

Head Office Tax (HOT) System for SMEs

The HOT System aims to mitigate the compliance challenges that SMEs face in their expansion within the internal market. This optional system would allow PEs to compute their taxable profits according to the rules of the head office State. Moreover, it would create a one-stop-shop in the head office State for filing, assessment and collection of tax.

To minimise concerns with abuse, the proposal is narrowly focused on standalone SMEs operating in other Member States via PEs. The option of expanding the rules to SMEs operating through subsidiaries was rejected as set out in the impact assessment that accompanies the proposal. The reasoning suggests that the focus on PEs is better aligned with the objective of targeting SMEs in the initial stage of expansion.

Additionally, the notion of SME itself provides further limitations. The proposal relies on the definitions set forth by Directive 2013/34/EU, which broadly classifies medium-size undertakings - the upper bound - as those that do not exceed at least two of the following three criteria, currently: (a) balance sheet total: EUR 20 million; (b) net turnover: EUR 40 million; (c) average number of employees during the financial year: 250.

Head offices that qualify as SMEs operating in other Member States exclusively through PEs should also meet other significant eligibility requirements:

A. The joint turnover of its PEs did not exceed, for the last two fiscal years, an amount equal to double the turnover generated by the head office;

B. It has been resident for tax purposes in the head office Member State during the last two fiscal years;

C. It has qualified as an SME for the last two fiscal years.

Qualifying head offices would benefit from one-stop-shop compliance (filing, assessment, collection) with the ‘filing authority,’ i.e., the competent authority of the head office State; and would be required to calculate their tax base using exclusively the rules of the head office Member State. However, tax rates and rules on the attribution of profits between head office and PE remain unaffected by HOT.

The proposal also delineates the interaction between the competent authorities of the head office and PE States. In short, the tax revenue that corresponds to PE profits would be collected by the filing authority and transferred to the Member State of the PE. Additionally, the proposal includes the possibility of joint audits at the request of the authorities of the PE State.

If approved, HOT is envisioned to apply from 1 January 2026.

Let’s talk

For a deeper discussion of how the BEFIT, Transfer Pricing and HOT System proposals might affect your business, please contact:

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