COMMISSION OF THE EUROPEAN COMMUNITIES

COM(94) 206 final

Brussels, 25.05.1994

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL
AND THE EUROPEAN PARLIAMENT

THE IMPROVEMENT
OF THE FISCAL ENVIRONMENT OF
SMALL AND MEDIUM SIZED ENTERPRISES

1. PURPOSE OF THE COMMUNICATION

The purpose of this communication is to set out the approach of the Commission in the field of the taxation of small and medium sized enterprises. It describes orientations towards a more favorable tax environment for small and medium sized enterprises, better suited to encourage their establishment and further development. The Commission is eager to have the largest possible discussion with Member States and other interested parties about these measures or any alternatives, so as to find the best way of dealing with the taxation of small and medium sized enterprises in the context of the White Paper on Growth, Competitiveness and Employment.

The current text only considers direct tax aspects of the environment of small and medium sized enterprises. As far as indirect taxation is concerned, measures will be proposed in the light of the reports and propositions arising in the framework of the revision of the value added tax and excise duties system, before the end of the year.

2. INTRODUCTION

2.1. General

In the Community, small and medium sized enterprises play a pre-eminent role both in economic growth and job creation. For instance enterprises with less than 500 employees account for 99% of the population of Union enterprises and generate 70% of private sector employment. Thirty per cent of all jobs in the Union are from self-employment or in micro-enterprises with less than 10 workers; small firms with less than 100 workers provide for 55% of employment. At the same time, the economic situation is not very favorable for small and medium sized enterprises. Consumers are consuming less and large enterprises are squeezing them on delivery conditions. Competition is growing, both from inside and outside the Community. To survive and grow, to improve their competitive position, and to be able to benefit from the economic stimulus of the GATS agreement, they need all the help that is available, as has been widely acknowledged by policy makers everywhere in the Community. At the Edinburgh Council in December 1992 improved support for small and medium sized enterprises was seen as one of the key elements to generate growth and in December 1993, both the White Paper on Growth, Competitiveness and Employment, and the Strategic Programme for the Internal Market, addressed small and medium sized enterprises as the bedrock of the Union economy and presented a number of issues to be explored. This

Communication takes up from there, identifying specific problems in the area of taxation and presenting an overview of possible orientations.

2.2. Subsidiarity

A very important consideration regarding taxation and small and medium sized enterprises is how far the subsidiarity principle applies. This Communication is based on the common policy goal that it is in the Community's interest to support small and medium sized enterprises. It also presents an orientation on some of the most urgent problems and suggests a number of alternative policy instruments; it is up to the Member States, given their own specific situation and their own specific legal environment, to address the problems and apply any of the solutions the Commission has provided for. The Commission does not intend to harmonize to any extent the purely national tax treatment of small and medium sized enterprises. Where domestic aspects are concerned, the Commission wants to recommend appropriate solutions on the basis of best practices, after having studied and compared the different systems in use in the Member States. These recommendations provide an incentive to the Member States to adapt parts of their system to improve the climate for small and medium sized enterprises. This approach is in accordance with the principle the Commission stated in its Communication of 26 June 1992[1] that "given the importance of taxation for Member States sovereignty and the principle of subsidiarity, Community action on business taxation should be limited to the minimum necessary to ensure that the internal market functions smoothly". On the other hand, there are certain areas in which only cross-border aspects of the taxation of small and medium sized enterprises are involved. If in those areas Member States were unable to take the appropriate measures individually, and if a more uniform approach was warranted, a legislative solution might be more suitable.

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1 Commission Communication to the Council and to Parliament subsequent to the conclusions of the Ruding Committee indicating guidelines on company taxation linked to the further development of the internal market, Commission of the European Communities, Brussels, 26 June 1992, SEC (92) 1118 final.

2.3. Three main problems

A first general problem faced by small and medium sized enterprises is their capacity to attract sufficient financial resources. Small and medium sized enterprises will be unable to take full advantage of the single market if their activities are constrained by a shortage of finance. Finding new financial resources is crucial, whether it is simply to maintain the business or to invest.

A second main problem for small and medium sized enterprises in the field of direct taxation is their incapability to cope with administrative complexity. As the White Paper indicated, administrative constraints fall disproportionately on small and medium sized enterprises, while small businesses have the least capacity to pass on costs, because they have little market power and the highest compliance cost.

A third problem is the continuity of the enterprise when its ownership changes.

These three types of problems are dealt with in this Communication, which tries to find solutions to them from different angles. While the most urgent problems are addressed, there may also be others. Some other areas for special attention are already indicated at the end of this Communication, the consultation process could bring forward yet others.

3. FINANCIAL RESOURCES

3.1. Self-financing

3.1.1. Introduction

In general, an enterprise can finance its operations by either resorting to internal resources, or by seeking access to external resources. The option of self-financing will normally be explored first. If small and medium sized enterprises can finance investment out of their own net-profits they are less dependent on outside sources, and can grow without being hampered by a lack of such resources. This is especially important in times of lower economic activity, when banks may be less prepared to lend their money to small companies, because of the higher risk of failure they run and their inability to provide collateral.

3.1.2. Problem

A large number of small and medium sized enterprises are subject to income tax, and not to corporate tax, which is applied to incorporated enterprises. Income taxes are normally progressive, that is to say that the higher the income, the higher the applicable tax rate. Corporate taxes are in general proportional; the applicable tax rate is constant, regardless of the amount of profit. As a consequence, in many Member States unincorporated enterprises have to pay more tax on their reinvested profits than incorporated enterprises, because they are subject to the highest bracket. The entrepreneur may then have to pay income tax at a rate of up to 60%, which leaves only 40% of the profit for re-investment in the enterprise. At the same time, in most Member States an incorporated small or medium sized enterprise pays a much lower corporate tax rate on the re-invested profits. The difference between corporate and non-incorporated marginal rates can be more than 30%. This puts unincorporated enterprises in a less favorable position than incorporated enterprises, and in fact this difference in taxation may lead them to a costly change in their legal structure, even if this is otherwise inappropriate.

3.1.3. Community orientation

Unlike other issues, the issue of the different tax treatment of incorporated and unincorporated enterprises has already been the focus of attention for some time. A measure which would improve the self-financing capacity of small and medium sized enterprises was one of the recommended actions of the Ruding Committee. It was endorsed by the Commission in its Communication subsequent to the conclusions of this Committee[2] and the Commission has since been studying the subject in depth, also taking into account the Member States' answers to a questionnaire. It is therefore the right time to address a Recommendation to the Member States on this subject, a copy of which is annexed, for information. The emphasis is on a limitation of the tax charges on re-invested profits.

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[2] In its Communication of 26 June 1992.

3.2. Fiscal treatment of venture capital

3.2.1. Introduction

A second topic regarding financing problems is that of the fiscal treatment of venture capital investments. Reinforcing self-financing would provide one solution for small and medium sized enterprises in need of additional financial resources, but it may not always be sufficient, particularly if the need for money is larger. Banks are not always in the position to lend money to high risk small enterprises, and if they are, small and medium sized enterprises may have to pay a higher price than large enterprises. Equity financing might even be harder to obtain. This is where venture capital can provide a suitable means to get access to external financial resources, which might also be more cost-effective. Venture capital is risk finance for private businesses, mainly in the form of long term equity-related investments.

Venture capital has been of particular importance in the United States (where the concept originated) and was responsible amongst other things for the successful development of "Silicon Valley". In some Member States venture capital funds play a valuable role in financing small and medium sized enterprises. A total of ECU 4.6 billion was invested by European venture capitalist investors in 1992. The amounts invested per Member State, in MECU, were the following[3]:

Belgium	142
Denmark	12
France	986
Germany	633
Greece	12
Ireland	26
Italy	510
Netherlands	239
Portugal	44
Spain	128
United Kingdom	1.831

3 Based on the 1993 European Venture Capital Association Yearbook by KPMG. No data available on Luxembourg.

It appears that venture capital investments are unevenly distributed over the Member States. There may be different reasons for this, for instance the general state of development of the financial sector, or the attitude of the banking sector towards lending to small and medium sized enterprises. Signals from the market indicate that the establishment of a well-developed venture capital sector is also highly influenced by the existence of an appropriate domestic legal structure, which can be used as a channel for venture capital investments. It appears that some Member States have no special regimes for venture capital investments. On the other hand, a special regime for venture capital investments might in practice not be used by investors, because they would consider certain crucial elements are lacking.

3.2.2. Solutions in Member States

The Member States with the largest venture capital investments, the United Kingdom and France, both have especially suitable instruments for venture capital investments, respectively the "limited partnership" and the "Fonds Commun de Placements à Risques" (FCPR) and "Société de Capital Risque" (SCR). The use of United Kingdom limited partnerships as a means of providing venture capital investment funds was specifically approved by the UK's Inland Revenue and the Department of Trade and Industry in 1987. In this respect it is worth noting that to achieve this no changes in legislation were necessary. The FCPR and SCR were created by special legislation, initially enacted in 1983 and 1985 respectively.

An important feature of the limited partnership and the FCPR is fiscal transparency, that is to say, the results of the venture capital fund are only taxed in the hands of the participants in the funds. The funds themselves are not taxed. This transparency prevents double taxation, which would otherwise arise because the fund would firstly be taxed on any capital gains or dividend distributions in respect of the investee company, and secondly the investor would be taxed on the same profits in respect of the shares in the venture capital fund. The general philosophy here is the so-called "look-through" approach, in which the investor is taxed as though there was direct investment in the target enterprise, and no venture capital fund in between. A second significant advantage of fiscal transparency is that investors may directly deduct from their income the losses resulting from the investments by the venture capital fund.

Another common feature of these structures is their limited liability, thereby reducing the risk for the investors to the amount they invested. A venture capital investor might be prepared to run the risk of losing 100% of the investment, but will almost certainly not be prepared to lose more than that. Structures without limited liability appear not to be used in practice.

Specific to the FCPR is a further extension of fiscal transparency. French investors in a FCPR are not normally subject to tax until they receive the relevant income from the fund: thus, if the income of the FCPR is reinvested by the FCPR, without any distribution to the investors holding shares in the FCPR, such investors are not taxed at that time. They are only taxed at the moment the FCPR distributes income to them.

The look-through approach could also be applied to withholding taxes on payments of interest or dividend from the target enterprises. Such a payment would then lead to the application of the double tax convention between the country of the investee enterprise and the investor, leaving out the venture capital fund. This could solve the problem that tax-transparent partnerships in a number of cases do not fall under the scope of the bilateral tax treaties between the Member States. When the tax treaty does not apply to the venture capital fund, the source state, where the dividend or interest is being paid, may withhold the maximum percentage of withholding taxes, without the reduction normally foreseen in the tax treaties.

3.2.3. Community orientation

The Community has already established a number of programmes to provide direct or indirect financial support in the venture capital area, like SPRINT, VENTURE CONSORT, EUROTECH CAPITAL and SEED-CAPITAL. In the field of taxation, until now, no Community initiatives have been developed. If it is true that the fact that both the United Kingdom and France have a well-developed venture capital sector is influenced by the availability of appropriate legal structures, other Member States might benefit from their experience and establish similar solutions, thereby providing their small and medium sized enterprises with additional means to find financial resources. The Commission is currently studying the situation in the other Member States. The result of this might be a more precise recommendation, on the basis of a "best-practices" approach.

The outcome might, however, be different if the international context is taken into consideration. In this context the general principle would be that the Community needs an efficient single market where investment decisions are not affected by distortions in national taxation systems. At present such a situation does not exist. A Limited Partnership, for example, is not treated as tax transparent by all Member States. This means that it cannot be effectively used for venture capital investments in all Member States. The ideal structure for a venture capital fund varies greatly between Member States. In some Member States there are no practical structures available for international funds. This creates a major obstacle to cross-border investment in venture capital funds. In a single market this is a rather unfortunate situation, which could probably only be solved by a more uniform approach. It is for consideration whether this should lead to a proposal for a legally binding instrument, or whether voluntary mutual recognition of fund structures as being tax transparent would be sufficient.

In this light it might be noted that seen from an somewhat broader perspective, the Union as a whole could benefit from a transparent solution, by which investors could set up pan-European structures, which would be treated in the same way all over the Union. Such a structure might lead to a increase in the capital inflow by venture capital investments from third countries, to the benefit of the Union's growth and employment.

4. ADMINISTRATIVE COMPLEXITY

4.1. Permanent establishments of small and medium sized enterprises

4.1.1. Introduction

It will be recalled that the White Paper noted that an important weakness of small and medium sized enterprises is their ability capacity to deal with the complexity of the administrative and legislative environment. This ability will be even smaller if it concerns the legislative environment of another Member State than the one in which the enterprise is resident.

Small and medium sized enterprises operate across borders by either:
- employing a local agent, for example selling products on a commission basis;
- setting up a foreign branch, which is more often referred to as a "permanent establishment"; or
- incorporating a subsidiary in the other state.

The first of these alternatives is the least complex: the SME has no "foreign" presence for direct tax purposes so there is no tax disincentive to expansion in that way. However, the SME equally has no control over the agent, and success or failure is entirely in the agent's hands. The other alternatives, permanent establishment or subsidiary, give the enterprise control over its foreign operations, but also require a direct tax presence in the other State. In principle nothing should be done once the step to establish a subsidiary is taken. The need to meet foreign accounting and regulatory requirements is an obligation that inevitably is connected with incorporated status.

Accordingly, the focus is here on permanent establishments, because small and medium sized enterprises would typically start their foreign operations using the less formal permanent establishment structure. For company law purposes, permanent establishments do not have to disclose any accounts which are related to their own activity. By contrast, for taxation purposes they have to present separate accounts. These "foreign" accounts are likely to involve considerable expense since it is unlikely that the accounts could be prepared on the same basis as for the home state; negotiations with the foreign authorities might also be necessary. To this administrative burden one has also to add further rules in the field of, for instance, social contributions, value added tax and environment policy. Presenting separate tax accounts is only one of the administrative obligations arising when an enterprise sets up a business abroad, but it is an important one, since direct tax legislation is a highly complicated matter and small and medium sized enterprises have to spend a lot of time and money on direct tax compliance; time and money which, especially in the start-up phase, could instead have been spent in trying to be successful in the new market abroad.

4.1.2. Solutions in Member States

At present, no specific rules on permanent establishments of small and medium sized enterprises exist. However, not all foreign activities of an enterprise are considered to form a permanent establishment. For instance, a building site or construction or installation project constitutes a permanent establishment only if it lasts more than a certain minimum period. If the minimum is not exceeded the enterprise is only taxed in the home country, not in the country of construction.

4.1.3. *Community orientation*

As in the case of building sites, the foreign activities of small and medium sized enterprises could, under certain conditions, be taxed only in the Member State of residence of the enterprise. This would imply a major administrative simplification for the enterprises concerned. Obviously a number of safeguards would need to be developed, to prevent abuse. The Commission is currently examining this very complex issue, and will decide on how to proceed further with the issue after consultations on the basis of this Communication.

5. CONTINUITY

5.1. Transmission of enterprises

5.1.1. *Introduction*

"Transmission" of ownership is something which affects virtually every business. Every firm will sooner or later have to face a change of ownership, although it is a particular problem for small and medium sized enterprises. National statistics show that the problem is indeed of some magnitude, with almost 10% of bankruptcies attributed to inadequate care being taken over the business succession issue. This is not to say that succession problems are the sole cause of business failures. But it should be of concern when they threaten the viability of otherwise healthy enterprises. It is estimated that a quarter of all firms employing between 50 and 1000 people will come up for a change of ownership over the next ten years. Nearly 3 out of 100 small and medium sized enterprises change hands each year. In cases of an unprepared transmission of the business, because of the death of the entrepreneur, high inheritance duties can threaten the life of the enterprise itself. If the inheritance duties are too high, the enterprise may have to be liquidated to pay them, leading to the destruction of capital and the loss of jobs. A related issue is the restructuring that is needed to prepare for the transmission of an enterprise, such as, for example, when a prior conversion of a partnership into a limited liability company is necessary. In such cases fiscal neutrality is of great importance. Measures designed to ensure the proper transmission of firms, and thus their survival, are of equal importance for the European economy as measures to stimulate the creation of new firms.

5.1.2. Solutions in Member States

Many Member States have rules in place to facilitate the transfer of an enterprise in the case of death of the owner. This can, for instance, take the form of a reduction of the rate of tax to pay, or a deferral of any unrealized capital gains until the inheritants realize them.

5.1.3. Community orientations

The Commission will elaborate an orientation aiming at a limitation of fiscal charges on succession or donation when the enterprise's activity is continued. In the same way a cross-border problem might also need to be addressed at Community level, as succession duties can be based on many different grounds: nationality of the deceased, nationality of the receiving party, residence of the deceased, residence of the receiving party, location of the property. These differences can give rise to double taxation. Bilateral conventions on estates, inheritances and gifts can prevent such double taxation, but at present, of the 66 possible bilateral relations between Member States, only 12 are covered by treaties to prevent the double taxation of inheritances. On the basis of the orientation extensive consultations will be started in order to finalize a possible recommendation and, if necessary, other appropriate action.

6. CONCLUSION

This Communication identifies priority issues for the improvement of the fiscal environment of small and medium sized enterprises. The individual issues do not stand alone; they can be interlinked, such as the issue of transfer of enterprises and that of venture capital: when an entrepreneur hands over a business to his or her successors, venture capital might equally be used to help finance a take-over or management buy-out.

A first initiative, in the form of a recommendation on the issue of self-financing is, for information, annexed to this Communication. An orientation paper by the Commission on the transfer of enterprises will follow shortly. For the other subjects, venture capital and permanent establishments, the Commission intends to start more detailed consultation with the Member States this autumn, in order to make it possible to define concrete action points by the end of this year.

These action points are about implementing the measures announced in the White Paper and the Strategic Programme for the Internal Market, with the aim of contributing substantially to the common goal of economic growth and especially the creation of jobs.

While the most urgent issues are addressed in this Communication, this does not mean that it covers all relevant tax issues for small and medium sized enterprises. For instance, the Commission may in the more distant future examine the taxation of partnerships. It might also address the tax treatment of European Economic Interest Groupings, a structure which European enterprises are now using more and more. A third subject for further consideration might be the so-called "Business Angel" concept, according to which profits from investments in shares of un-quoted companies may be rolled over if re-invested in such shares.

The Commission repeats its invitation to Member States and all other interested parties to communicate their ideas and comments regarding this document, including any issues omitted.

ISSN 0254-1475

COM(94) 206 final

DOCUMENTS

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Catalogue number : CB-CO-94-222-EN-C

ISBN 92-77-69268-5

Office for Official Publications of the European Communities
L-2985 Luxembourg