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Position Paper

on the Proposal for a Council Directive laying down rules on a debt-equity bias reduction allowance and on limiting the deductibility of interest for corporate income tax purposes (DEBRA)

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About ETAF
The European Tax Adviser Federation is a European umbrella organisation for tax professionals whose activities are regulated by law. It is set as an international not-for-profit organisation (AISBL) governed by Belgian law, based in Brussels and was launched on 15th December 2015. ETAF represents more than 215,000 tax professionals from France, Germany, Belgium, Romania, Hungary and Austria.

Introduction

On 11 May 2022, the European Commission presented its proposal for a debt-equity bias reduction allowance (DEBRA), combining two separate measures:

1. an allowance for new equity,
2. a limitation to the deductibility of debt costs.

The objective of this proposal is to ensure that equity receives similar tax treatment as debt, so that companies can consider both options on an equal footing and choose the source of financing that is best for their business-model.

In principle, the European Tax Adviser Federation (ETAF) recognizes that high levels of debt make companies in the EU more vulnerable to insolvency and that they should be encouraged to use less debt financing and more equity financing. From an economic point of view, neutrality in financing should be favoured. Specifically, for long-term investments with a high degree of risk it can be difficult to find lenders. We believe that improving the conditions for equity financing can help promote much needed investments in the fields of digitalisation, sustainability and climate protection.

Nevertheless, we have identified some inconsistencies in the proposed directive and would like to comment on them in this paper.

I. General Remarks

According to the principle of subsidiarity, the EU may only act if the objectives cannot be sufficiently achieved by the Member States themselves and can be better achieved at EU level because of their scale and effects. Whether action by the EU is actually necessary in the present case is not clear in our opinion.
Supporting companies in using equity resources can be done on national level: Six EU Member States (Belgium, Poland, Portugal, Malta, Cyprus and Italy) have already implemented rules against debt financing incentives. Yet, harmonising these rules on EU level is not necessarily a must.

According to the principle of proportionality, the EU's legislative measures may not go beyond what is necessary to achieve the objectives of the treaties. The implementation of the present provisions would exceed this principle.
This is especially true for the provision of article 6 which regulates the limitation of interest deduction. This is supposed to ensure sustainability of the measures for the budgets of the Member States. However, the competence for national budgets lies clearly with the individual Member States.

A partial prohibition of interest deductions differs qualitatively from the interest limitation rules (ILR) laid down in the ATAD. The ILR was introduced in order to combat abuse. The fight against abuse is rightly located at EU level in order to ensure uniform application in the Member States and to avoid distortions within the single market. However, the present directive does not provide for a justification of such a new rule. In our view, article 6 of the proposed directive would not improve the functioning of the single market, which is essential to the provision of article 115 TFEU.

A ban on deducting interests on debt financing would de-facto increase corporate income tax if the non-deductible debt interest is higher than the deductible allowance for equity or if claiming the allowance is not possible. It is not clear how this would fundamentally improve the functioning of the single market.

II. Allowance for new equity

Article 4 of the directive lays down rules for an allowance for new equity. The allowance on equity is deductible for 10 consecutive tax years, as long as it does not exceed 30% of the taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA). If the allowance on equity is higher than the taxpayer's EBITDA, the taxpayer may carry forward the excess of allowance on equity without a time limitation. Taxpayers will also be able to carry forward their unused allowance on equity which exceeds the 30% of taxpayers EBITDA, for a maximum of 5 tax years.

The percentage of 30% as well as the mentioned EBITDA appear to be based on the ILR introduced with the ATAD. However, there is no clear reference to the ATAD in the proposed directive. It remains unclear whether the EBITDA in the DEBRA proposal corresponds to the compensable EBITDA of the ATAD. Given that both directives have different objectives - ATAD's primary objective is to prevent abuse, DEBRA's is to eliminate equity discrimination and to support resilience and an increased propensity to invest - it should be justified in more detail why a 30% cap is considered appropriate in both cases.

If the tax base for the allowance is negative after it has been claimed in a tax period, an amount equal to the negative allowance is to be taxed subsequently. This regulation raises some questions.

Subsequent taxation could be carried out even after the end of the ten-year period in which the allowance was claimed. In our opinion, such a regulation would be too excessive. At the very least, the relevant period must be specified. The allowance should also only apply to *new* equity.
If equity capital increases over a period of several years and then declines, the most recently used allowance should be subject to subsequent taxation, but not all allowances that have ever been claimed.

III. Anti-Abuse Rules

Companies do not make their decisions based primarily on possible tax implications. In order to be successful on the market in the long term, decisions must be based on business management considerations. Only in a next step most companies attempt to avoid negative tax consequences. We therefore consider it problematic to define certain actions as abusive per se, especially if the taxpayers are not given the opportunity to exculpate themselves, i.e. to disclose the economic reasons for their decisions and thus avert the classification as abusive. This applies, for example, to the increase in equity in the case of restructurings referred to in paragraph 3 of article 5 of the proposed directive.

We highly doubt that regulations such as paragraph 2 on a capital increase through a contribution in kind or an investment in an asset are necessary. The decision as to whether

an asset is necessary for the taxpayer to carry out its income-generating activities is primarily for the respective company to make.
Moreover, it is not evident why for shares only the book value should be considered, but for other assets the market value.
We suggest that the possibility of proving economic reasons as provided for in paragraph 1 should be extended to the entire article 5, since we do not believe that all of the processes mentioned in article 5 should always be understood as abuse.

IV. The limitation to the deductibility of debt costs

The proposed directive provides for a limitation to the tax deductibility of debt-related interest payments. In particular, a proportional restriction will limit the deductibility of interest to 85% of exceeding borrowing costs (i.e. interest paid minus interest received). Here, the Commission explicitly refers to the provisions of the ATAD.

Given that interest limitation rules already apply in the EU under Article 4 of the ATAD, the taxpayer will apply the rule of Article 6 of this proposal as a first step and then calculate the limitation applicable in accordance with article 4 of the ATAD. If the result is a lower deductible amount, the taxpayer will be entitled to carry forward or back the difference in accordance with Article 4 of the ATAD.

Nevertheless, we are missing the possibility of exceptions for non-group companies or for a de minimis limit (€3 million) below which a full deduction of interest expenses remains possible, like it is provided for in the ATAD.
This might especially become problematic for SMEs, who often do not have the choice between equity and debt financing.