



7 October 2021

Attn Mr Bernardus Zuidendorp
DG TAXUD
European Commission
1049 Bruxelles
Belgium

Dear Mr Zuidendorp,

Subject: Debt Equity Bias Reduction Allowance ('DEBRA') proposal

PwC International Ltd (PwC), on behalf of the PwC network, welcomes the opportunity to respond to the public consultation on the DEBRA proposal.

Introduction

PwC agrees that there is a need for a more tax neutral treatment of debt and equity and the fact that the tax system does not reward equity investment is indeed a long-standing issue.

Our comments will address the following themes:

1. The policy objectives of DEBRA;
2. Considerations on taxing economic rent;
3. Economic impact and impact on accessibility of capital markets of an allowance for corporate equity, and
4. Design and implementation considerations

1. The policy objectives of DEBRA

- We note from the Inception Impact Assessment (IIA) that the objective is to reward equity investment, thereby reducing the overall debt-leverage of companies, while supporting the economic recovery from the COVID crisis. While the first two objectives are permanent in nature, the objective to support economic recovery from the COVID crisis is a temporary one likely to require a scheme with different characteristics, or an alternative form of allowance.

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- In addition to the afore-mentioned objectives, the IIA adds that DEBRA will support the creation of a harmonised tax environment. This would further support the upcoming Commission's Business in Europe: Framework for Income Taxation (BEFIT) initiative. Additional clarity would be welcome as to how DEBRA fits within the broader BEFIT agenda, and what the implications are for the choice of legislative instrument.
- Finally, there may be other policy issues to consider, including who will benefit from the allowance and whether there are some types of businesses in particular that this measure would be targeted towards.
- In the context of BEPS Action 4, ATAD, and updated transfer pricing guidance on debt capacity and associated deductions for interest on highly debt-leveraged businesses, countries have taken steps to reduce interest deductibility. The proposed OECD Pillar Two rules will further reduce the impact of interest deductions (via the IIR/UTPR which will limit deductibility for interest expenses to the extent that they result in a level of tax below the minimum acceptable rate).
- The introduction of these measures has resulted in a complex range of rules to be adhered to which has been very hard to navigate through and to implement, both for multinational taxpayers and for tax administrations. The landscape is settling somewhat as implementation of the minimum standards across the EU is almost complete and businesses grow more accustomed to dealing with the different rules. Given this delicate stage, we strongly believe that taking any further steps to limit interest deductions would exacerbate this complexity and would hamper economic growth unnecessarily, because the risk of interest that is deductible nowhere increases commensurately with additional measures.

2. Taxing economic rent

- A more tax neutral treatment of debt and equity via the introduction of an allowance for corporate equity ('ACE') would have a number of advantages compared to the current Corporate Income Tax (CIT) design:
 - The ACE can be implemented without significant restructuring of the existing corporate tax system or the limitation of any existing reliefs, including the otherwise deductible interest on debt;
 - Extensive data is available to businesses, tax advisors and tax authorities to determine what an appropriate rate of return is on both a "risk-free" basis and including a risk premium;
 - Allowing a deduction for the 'opportunity cost' of equity finance can be done in two ways: either as a counterpart to allowing the interest cost of debt finance to be tax deductible, or as a series of instalment tax allowances which compensate

for the absence of the up-front 100% allowance for equity-financed investment expenditure provided by the cash-flow taxes.

- If the main objective is to enhance equity investment to support both existing enterprises as well as innovative investments, the following key design features of the new scheme could be considered:
 - The fact that business needs to build in buffers for any unforeseen future crisis;
 - If the main objective of DEBRA is to rebalance the debt-equity bias by reducing the debt-leverage on a long-lasting basis, a deduction on the full equity basis (essentially a “full ACE”) would seem to best support this objective. This will treat new and existing investments on an equal footing and will leave less room for abuse of the scheme. However, such a design feature will have a significant impact on the tax revenues of Member States. Noting that the European Commission suggests that this measure would be a cost-neutral change from a budgetary perspective, the cost would need to be limited either on the allowance side or possibly through additional tax-raising measures elsewhere;
 - If the main objective of DEBRA is to (temporarily) support the economic recovery from the COVID crisis by restoring the equity basis, a deduction on the incremental equity only may be better aligned with such objective
 - An allowance on corporate financial capital (financial debt+equity) may benefit certain businesses more than others. For example, it is most likely to benefit less cyclical businesses compared to businesses that are sensitive to economic trends, whereas the first group are most likely already benefiting from more competitive conditions on their external debt, including lower interest rates on debt financing. This could lead to a notional deduction percentage on their full financial capital that might be higher than their actual cost of debt. By contrast, more cyclical businesses most likely are already facing more expensive funding conditions on their external debt, and the notional deduction percentage will likely be lower than their actual cost of debt (based on the risk-free and premium rates outlined in the IIA). Start-ups and scale-ups, who have an important role to play in long-term economic growth, are likely to be in a similar position. Inadvertently benefitting established businesses may therefore limit the potential achievement of one of the main policy objectives (supporting the economic recovery);
 - A distinction based on the origin or nature of equity would be less effective in realising the policy objective of decreasing debt leverage levels. This also would make the implementation of the instrument very complex;
 - For the rate, the current questionnaire considers a floating risk-free rate possibly increased with a risk premium. While the risk-free rate might be a fair measure to reflect the general interest rate environment, an additional risk premium might further bridge the debt equity gap. The latter might be of particular importance for more innovative and thus riskier investments;

- Aligning the rate with what would have been payable on a third party debt for an equivalent amount seems systematically appropriate, including where interest rates remain low or negative. A risk premium would be needed to fully reflect the profile of the investment and the investee. An ACE could be most precisely targeted if the rate would be determined per taxpayer. That would probably lead to an unimplementable solution,
- More clarity is welcomed as to whether the European Commission is considering any specific application of the ACE that would provide equal treatment for SMEs and MNEs.
- An ACE may lead to unintended mismatches, certainly if it is introduced on a unilateral basis. Even if an ACE would be implemented by all Member States, and depends on the choice of instrument, one could regard this as a unilateral measure in relation to countries outside the EU, which would require anti-abuse measures.
- Further clarification of the interaction between the DEBRA and the anti-hybrid rules would be welcome, also to ensure that the DEBRA would not unintentionally trigger the current EU anti-hybrid rules.
- A specific point that will require further consideration is whether there will be a taxable pick-up of the ACE in the hands of the investor (or indeed, whether the pick-up is attributed to another member of an MNE group). This consideration will be a fundamental design decision and will determine whether rebalancing towards equity can be fully addressed. An ACE is not equal to a transaction between enterprises (associated or unassociated) nor is it a downward adjustment for not using arm's-length conditions and prices. An ACE reflects that the cost of capital also reduces the taxable profit. The profit will either be re-invested or distributed to the shareholders as dividend. Dividends that eventually are taxed at the level of each shareholder (individuals, participants in investment funds, pension funds etc.). From this perspective one could raise the question if introducing the requirement of a taxable pick up reflects good tax policy, and whether this would introduce yet another form of debt-equity bias.

3. Economic impact and impact on accessibility to capital markets

Economic impact

- The financial cost to the Member States of providing an ACE could be significant and could impact domestic budgets. It is noted that the measure would need to be compensated to remain budget neutral. Given the current uncertainties that exist around effective corporate tax rates as a result of the OECD Pillar Two proposals, it may be best to allow Member States to decide the most appropriate offsetting measures at local level.
- The impact of an incremental ACE seems to be more moderate, at least in the years following the introduction. An incremental ACE, which we believe would result in an

incremental increase in equity investment, may help to address more immediate (but temporary) business concerns which continue to be centered on cash flow and availability of funds rather than plans to invest heavily in capex (which may require higher investment levels).

- Another option may be a full ACE combined with a positive adjustment of the tax base in the case of a business with low or negative equity.

Accessibility of capital markets

- Equity recapitalisation is needed to ensure that businesses can access sufficient levels of funding to ensure their recovery from the challenges posed by COVID-19. A recent report shows that there will be an equity financing need in the EU of €1 trillion over a two-year period, with only €400-€550 billion of EU-wide public and private sector equity available to meet this need, leaving a €450-€600 billion shortfall. Tax policy is one of the levers that can be pulled to promote equity recapitalisation to meet this funding shortfall, but certainly not the only one and maybe not the most important one.

4. Design and implementation considerations

- Definitions of the key concepts (the equity basis on what an allowance would be calculated, the allowance ate, etc.) will need to be clear and understandable in order to accommodate different financial reporting standards and existing national definitions in existence.
- As noted above, according to the IIA the initiative supports the upcoming Commission's BEFIT initiative. The DEBRA initiative could be a first step towards a future common EU corporate income tax framework as the European Commission indicated. . In order to retain flexibility the European Commission may wish to consider providing principle-based guidance for Member States, while the broader framework (including the equity allowance) is fully worked out.

Conclusion

Enhancing equity investment in corporate income taxes is important to achieve more tax neutrality and to stimulate companies to build buffers for any next crisis. Further limitations of interest deductions are likely to have adverse consequences. Introducing an ACE has a number of clear advantages. Whether an ACE would offer equal benefits to all businesses, including SMEs, start-ups and those already paying high interest rates on debt requires research. An ACE may have a significant impact on the tax revenues of a country, depending on scope and design.



If the loss of tax revenue would need to be absorbed by for example an increase of the tax rate, further research would be needed to understand the distributional effects and the broader economic and behavioral impact. In further research it is important to address the tax treatment of the holder of the equity or the debt. The question on how an ACE might coexist with other, often recently introduced, measures, including interest limitation and anti-hybrid rules, but also with a future corporate income tax system for the EU, would need careful consideration.

For any clarification on this response, please contact me or any of the contacts below. We look forward to discussing any questions you have on the points we raise above. We would welcome the opportunity to contribute to the discussion.

Yours faithfully

A handwritten signature in black ink, appearing to read "S. van Weeghel".

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