EU Commission publishes proposal to implement debt-equity bias reduction allowance ('DEBRA')

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In brief

The European Commission has published an EU Directive proposal regarding a debt-equity bias reduction allowance (DEBRA) and a limitation of the tax deductibility of exceeding borrowing costs (the proposal). This proposal, published 11 May 2022, is one of the Commission's key actions on corporate tax, as set out in the Communication on Business Taxation for the 21st Century.

The proposal aims to address the disparity in treatment between debt and equity financing by introducing a tax-deductible allowance for equity investments over a 10-year period, as well as further limiting the ability to deduct interest on debt investments. The restriction on deducting debt interest will interact with the existing interest limitation rule (ILR) under Article 4 of the Anti-Tax Avoidance Directive (ATAD).

The proposed rules would apply to taxpayers that are subject to corporate income tax in one or more EU Member States, including permanent establishments of non-EU head offices. The proposed rules do not apply to financial undertakings (as exclusively defined in the proposal).

Member States that already apply an allowance on equity under their national law may postpone application of the rules for a period up to 10 years and in no case for a period longer than the duration of the benefit under national law.

Interested parties may comment on the proposal via the European Commission website until 8 July 2022.

In detail

Background

According to the European Commission the background to this proposal lies in the significant increase in debt financing by business in recent years. Increased levels of debt are attributed to the need for cash injections during the global pandemic. The fact that the investments in businesses were made through debt financing rather than equity investments, is attributed to the disparity in tax treatment that exists between debt and equity financing. Debt

financing is seen as favourable for businesses given the ability to deduct interest on debt from the taxable business profits.

The Commission would like to encourage more sustainable and less risky growth and investment in the Single Market, and increasing levels of equity financing is seen as key to this. This proposal, it is stated, is one of the measures that will complement a move to a more harmonised corporate tax system for businesses operating in the European Union. Ultimately, it would support the move to a common tax rulebook under the Business in Europe: Framework for Income Taxation (BEFIT) objective.

Scope

The proposal applies to all taxpayers that are subject to corporate tax in one or more Member States, including a PE in one or more EU Member States of an entity that is tax resident in a third-country. This proposal does not apply to financial undertakings (as defined in the proposal).

A new allowance for corporate equity

The proposal allows companies to deduct an allowance on equity from its taxable base for 10 consecutive periods, where a taxpayer increases their equity from one tax period to the next. The allowance on equity is computed by multiplying the allowance base with the relevant notional interest rate.

Allowance on equity = Allowance Base X Notional Interest Rate (NIR)

The allowance base is equal to the difference between equity at the end of the tax year and equity at the end of the previous tax year — that is, the year-on-year increase in equity. Equity is the sum of paid-up capital, share premium account, revaluation reserve and reserves

[1] and profits or losses carried forward.[2] Net equity is then defined as the difference between the equity of a taxpayer and the sum of the tax value of its participation in the capital of associated enterprises and of its own shares. The Commission notes that this definition is meant to prevent cascading the allowance through participations.

The applicable interest rate is a currency specific risk free rate for 10-year debt. This rate is combined with a risk premium rate of 1%. A higher risk premium interest rate (1.5%) is proposed for SMEs.

Notional Interest Rate (NIR) = Risk Free Rate + Risk Premium

Risk Premium = 1% (or 1.5% for SMEs)
The allowance is limited to 30% of EBITDA. If the allowance exceeds the taxpayer's net taxable income, the part of the allowance on equity that would not be deducted in a tax year due to insufficient taxable profit may be carried forward indefinitely to future periods. Any unused allowance capacity (where the allowance exceeds 30% of EBITDA) can also be carried forward and used for a maximum of five years to reinforce parity with the ILR.

A reduction in the equity after the taxpayer obtained the allowance on equity, based on this proposal, results in the taxation of a proportionate amount over 10 consecutive tax periods and up to the total increase of net equity for which such allowance has been obtained, unless the taxpayer can demonstrate that the decrease of equity is a consequence of accounting losses incurred in the period, or due to a legal obligation to reduce capital.

Observation: Financial undertakings are carved out from this proposal. However, the list of financial undertakings in Article 2 of this proposal differs from the list of financial undertakings provided in Article 2(5) of ATAD. Accordingly, some businesses may find that they are excluded from DEBRA, but not from ATAD ILR. As a result

they will potentially be subject to a restriction of deductible interest under ATAD ILR, but will not be in a position to benefit from the allowance for equity provided as a result of DEBRA. The financial undertakings listed in Article 2 of this proposal will not be subject to the additional restriction on interest deductions set out in the below section.

Further restriction on deducting interest in debt financing

To further reinforce parity between debt and equity and to preserve the sustainability of Member States' public finances, the allowance for notional interest on equity is accompanied by an additional limitation to the tax deductibility of debt-related interest payments. A proportional restriction will limit the deductibility of interest on debt financing to 85% of exceeding borrowing costs as defined in ATAD Article 1(2) (i.e interest paid minus interest received). This restriction applies before applying the ATAD ILR.

If the result of applying the ILR is an amount lower than 85% of exceeding borrowing costs, the taxpayer will be entitled to carry forward or back the difference between 85% of exceeding borrowing costs and the amount of deductible interest under the ILR, in accordance with the ILR e.g., if a company has exceeding borrowing costs of 100, it should:

1. Under DEBRA, the limitation to the deductibility to 85% of the exceeding borrowing costs of 100 leads to a non-deductible amount of 100-85=15.
2. Compute the amount that would be deductible under the ILR of ATAD. If we assume that this amount is **80**, the non-deductible amount subsequently is 100-80=20.
3. The difference in the deductibility (i.e., the additional non-deductible amount under the ILR) is 85-80 = **5** and would be carried forward or back in accordance with the ILR.

In the above example, the outcome for the company is that 15 (100 - 85) of interest borrowing costs are non-deductible and a further 5 (85 – 80) of interest borrowing costs are carried forward or back. In the absence of DEBRA, the taxpayer would be in a better position as the 20 calculated in (2) could be carried forward indefinitely. With the DEBRA restriction, the deduction for the 15 is lost to the taxpayer on a permanent basis (i.e., no carryforward).

Observation: For taxpayers who make use of the equity-escape carve out, such that the ILR does not apply to restrict interest expense deductibility, this will result in a restriction of the deductible amount to 85% of the exceeding borrowing cost, whereas previously there was no restriction. For businesses who use the group ratio rule to increase the deductibility of interest beyond 30% of EBITDA, their subsidiaries will nevertheless be facing (permanent) non-deductible interest restrictions up to the 15% of the exceeding borrowing costs.

SMEs or businesses who would have made use of the various ILR carve-outs, notably the de-minimis threshold, the long-term infrastructure carve-out, or others, will face a restriction on interest where none previously existed as a result of the ILR. Accordingly, this interest restriction element of the proposal would appear to make it less attractive for investors to provide debt financing to such businesses.

Interactions with GloBE rules

It is also questionable how material the relief that businesses will be able to avail of through an equity allowance will be, particularly in a post-GloBE environment.

Financial statements, on which the GloBE income will be heavily reliant, will not account for this notional interest deduction, and so it is probable that the GloBE income will be higher than the local taxable profits after accounting for the equity allowance in the local tax return. In terms of covered taxes, if a business avails of the DEBRA equity

allowance (ignoring the debt restriction) it should have less local tax payable, thereby resulting in a lower effective tax rate as a direct result of the use of the DEBRA equity allowance.

The DEBRA debt restriction to 85% of the exceeding borrowing costs may mitigate this impact, through increasing the local taxable profits, but not in all circumstances. In the event that a taxpayer had been subject to the ILR restriction on exceeding borrowing costs, it's likely that the amount of current year deductible interest will not change the local tax liability (there may be a deferred tax impact to the extent that the amount of carried forward ILR exceeding borrowing costs is reduced after applying the DEBRA restriction). The ETR for the year in question therefore remains lower than before DEBRA is applied.

Taxpayers that had not been subject to the ILR in the past may see an increase in the amount of taxable profits as a result of the DEBRA debt restriction. This may be neutralised by a deduction for a DEBRA equity allowance.

It would have been helpful to see the Commission publish an economic impact assessment, or illustrative examples, to illustrate the economic outcome accounting for both types of scenarios.

Anti-abuse measures

Article 5 of the proposal covers anti-abuse rules. These anti-abuse rules are inspired by the Guidance on notional interest deduction regimes which was adopted by the Code of Conduct Group in 2019.

Article 5 stipulates that the base of the allowance on equity does not include the amount of any increase which is the result of:

- granting loans between associated enterprises;
- a transfer between associated enterprises of participations or of a business activity as a going concern;
- a contribution in cash from a person resident for tax purposes in a jurisdiction that does not exchange information with the Member State in which the taxpayer seeks to deduct the allowance on equity.

These anti-abuse provisions should not apply if the taxpayer provides sufficient evidence that the relevant transaction has taken place for valid commercial reasons and does not lead to a double deduction of the defined allowance on equity.

Furthermore, the proposal states that where an increase in equity is the result of a contribution in kind or investment in an asset, Member States shall take appropriate measures to ensure that the value of the asset is taken into account for the calculation of the base of the allowance only where the asset is necessary for the performance of the taxpayer's income-generating activity. The Commission notes that this rule aims to prevent the overvaluation of assets or purchase of luxury goods for the purpose of increasing the base of the allowance.

In the case where an increase in equity is the result of a reorganisation of a group, the increase in equity shall only be taken into account to the extent that it does not result in converting the equity (or part thereof) that already existed in the group before the reorganisation into new equity. The Commission states that this re-categorisation of old capital as new capital could be achieved through a liquidation and the creation of start-ups.

Existing equity allowance regimes

A small number of countries have existing regimes that allow for a tax deduction based on an equity allowance (Belgium, Portugal, Poland, Cyprus, Malta and Italy). Such regimes typically involve a notional interest deduction (NID) regime, whereby a notional interest deduction is granted for new equity investments, or a fraction of new

equity invested in a given year. The length of the period over which the allowance is granted varies from country to country, as does the interest rate applicable. NID regimes typically do not include a concept of a negative allowance, unlike the proposed Directive. Instead, a reduction in equity may see a reduction in the NID basis. The restrictions applied to the base of the allowance vary in comparison to the DEBRA proposal and might include, for example, intercompany investment. Additionally, what is considered to be 'equity' under existing NID regimes differs from the definition provided in this proposal. NID regimes typically do not include a restriction on the deductibility of interest on debt investments, other than what is required under the ILR.

Observation: Based on the provisions of the proposal, countries with NID or other equity allowance regimes may retain such national rules for a period of up to 10 years for taxpayers already benefiting from the local rules as at 1 January 2024. A number of factors are likely to come into play when a country with an existing regime decides whether to retain the existing rules for the transition period, or move to a DEBRA equity allowance. This will include consideration of the impact on national tax revenues, factoring in the impact of tax revenues potentially foregone as a result of the DEBRA debt restriction. Note: the deferral of introducing the rules by the stated countries applies in respect of 'the provisions of this directive,' meaning that the countries may also defer the application of the DEBRA further restriction on deducting interest in debt financing.

The takeaway

The introduction of a notional interest on incremental equity is to be welcomed because this reduces the debt-bias in the tax system, rebalancing the use of equity, and leads to a more neutral taxation on economic rent. The introduction of a further, and more impactful, restriction on the ability of a business to deduct exceeding borrowing costs related to debt financing will be an unwelcome surprise for many taxpayers. For taxpayers that avail themselves of the equity-escape carve out, the group ratio rule, or any of the carve-outs that are provided for in the ILR, this suggests the Commission intends to prevent such taxpayers from availing themselves of tax relief related to genuine costs of doing business. The lack of carve-outs that are commonly available under the ILR is also noteworthy.

Given the already existing ILR, it is not clear why an additional ILR is considered to be necessary from a conceptual and systemic point of view. A further ILR may make the proposal budget-neutral and therefore may be acceptable for Member States, although an impact assessment at the Member States level is not available.

The proposal makes no distinction between external and intercompany financing. Therefore, groups may have to reassess their funding mix taking into account both the allowance for equity and the additional IRL.

As with all proposals that relate to direct tax, in order for this proposal to progress, unanimity is required from all 27 EU Member States. If adopted, an EU Member State shall implement the provisions of the EU Directive by [31 of December 2023] and apply them from [1 January 2024] (the dates are presented in square brackets in the proposal, indicating that they may be subject to change).

Let's talk

For a deeper discussion of how the DEBRA proposal might affect your business, please contact:

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[1] Reserves include: 1. Legal reserve, in so far as national law requires such a reserve; 2. Reserve for own shares, in so far as national law requires such a reserve, without prejudice to point (b) of Article 24(1) of Directive 2012/30/EU; 3. Reserves provided for by the articles of association; 4. Other reserves, including the fair value reserve

[2] A reference is made to Directive 2013/34/EU (Accounting Directive)