BRIEFING

EU Legislation in Progress

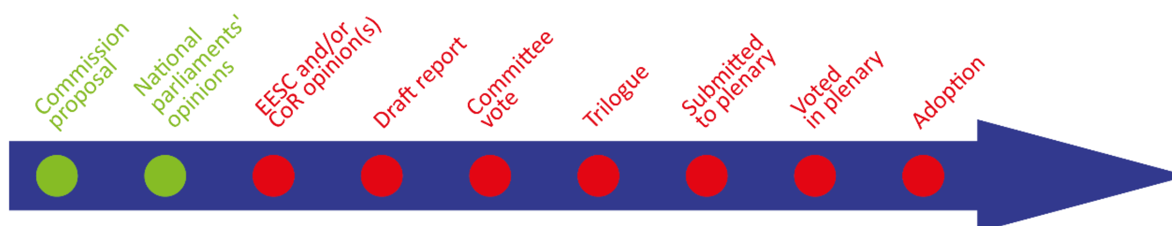
European Parliament

Debt-equity bias reduction allowance (DEBRA)

SUMMARY

In most countries in the European Union (EU) and in the rest of the world, debt is treated more favourably from a tax perspective than equity, with interest payments to loans generally being tax deductible. In contrast, costs related to equity financing, such as dividends, are mostly non-tax deductible. This unequal treatment between debt and equity induces a bias towards debt in businesses' investment decisions and can therefore lead to high levels of indebtedness in the European corporate sector. On 11 May 2022, to support the creation of a harmonised tax environment that places debt and equity financing on an equal footing across the EU, the European Commission presented a proposal for a debt-equity bias reduction allowance (DEBRA). The DEBRA lays down rules on both a tax allowance on increases in equity and on a limitation of the tax deductibility of interest payments.

Proposal for a debt-equity bias reduction allowance and limiting the deductibility of interest for corporate income tax purposes		
Committee responsible:	Economic and Monetary Affairs (ECON)	COM(2022)0216 11.5.2022
Rapporteur:	Luděk Niedermayer (EPP, Czechia)	2022/0154(CNS)
Shadow rapporteurs:	Evelyn Regner (S&D, Austria) Gilles Boyer (Renew, France) Gunnar Beck (ID, Germany) Michiel Hoogeveen (ECR, Netherlands)	Consultation procedure (CNS) – Parliament adopts a non-binding opinion
Next steps expected:	Publication of draft report	



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Introduction

The European Commission's initiatives concerning corporate income taxation are part of the Commission's broader taxation agenda, which aims at a tax system guided by the principles of fairness, efficiency and simplicity in order to strengthen the single market, alongside a balanced tax revenue mix. The Commission highlighted two priorities in the area of business taxation: a) enabling fair and sustainable growth and b) ensuring effective taxation.

Regarding the first priority, the Commission underlined the importance of adapting the tax framework, to bring it in line with the EU Green Deal (e.g. through the revision of the Energy Taxation Directive), as well as with the need for simplicity for taxpayers, particularly in the area of value added tax (tax action plan). Corporate tax policy should also support the development of the capital markets union, (CMU), in particular by removing tax barriers to cross-border investment and addressing the debt bias in taxation.

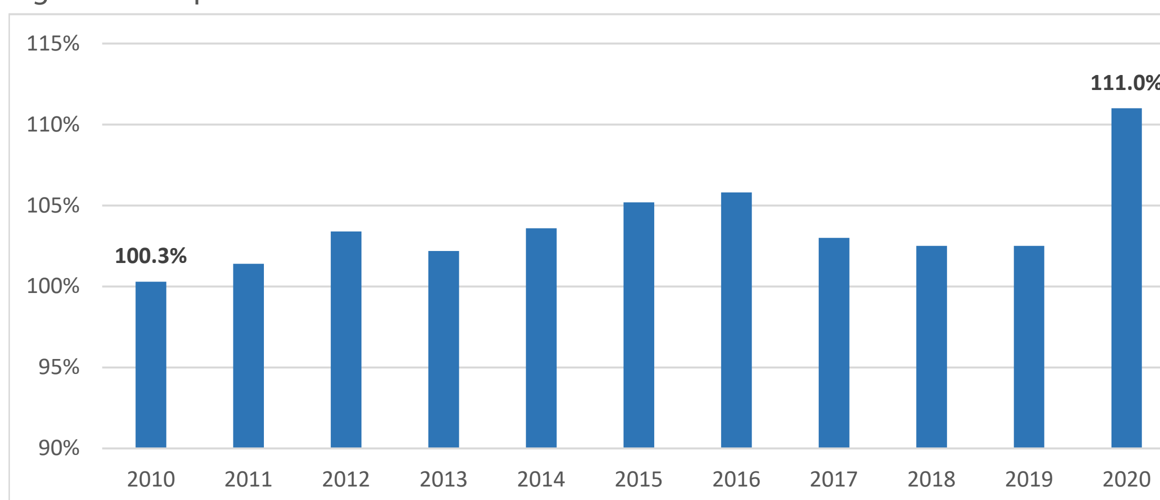
In terms of the second priority, improving the effective taxation of taxpayers, it was noted that the collection of tax revenue, including through the fight against aggressive tax planning, tax evasion and tax fraud, is vital to fund quality public services.

Context

In most countries in the EU (and in the rest of the world), debt is treated more favourably from a tax perspective than equity, with interest payments to loans generally being tax deductible. In contrast, costs related to equity financing, such as dividends, are mostly non-tax deductible. Consequently, by choosing debt to finance an investment, a company can increase after-tax profit compared to financing an investment through an equity increase. This asymmetric treatment between debt and equity induces a bias towards debt in businesses' investment decisions and can therefore lead to high levels of indebtedness in the European corporate sector. Such a situation, in particular during an economic crisis, makes companies vulnerable to insolvency and may further lead to instability in the banking sector and the broader EU economy in the longer term. The Commission estimates that the revenue costs of the existing deductibility of interest for non-financial corporations may be roughly €64 billion.[1]

The COVID-19 crisis made addressing the corporate debt bias even more pressing, with many companies having to rely on debt financing in order to cover economic losses as a result of the pandemic. While corporate debt[2] represented 100 % of EU gross domestic product (GDP) in 2010 (or €11 trillion), it increased to 111 % of EU GDP (or €14.9 trillion) in 2020.

Figure 1 – Corporate debt as a % of EU GDP



Source: Eurostat, Financial liabilities of non-financial corporations

At the same time, the preference for debt over equity may not always be motivated by tax reasons. In this context, the Commission notes that 'debt could be chosen to increase the return on equity, because access to equity financing is limited and because debt financing is cheaper than equity financing (especially when interest rates are low), to diversify risk, to reduce tax liabilities, and to avoid the dilution of control/voting rights of existing equity holders (owners)'.

The role of equity (and the bias towards debt in taxation) is also frequently mentioned in the context of the green transition. As significant and sometimes risky investments in innovative technologies will be needed to reach the EU Green Deal objectives, the European Investment Bank considers that 'the transition is likelier to be financed by risk-taking and risk-absorbing instruments such as equity'. The situation is especially concerning for small and young companies who may be working on innovative green solutions, but whose risk profile would limit access to external debt funding. A study by the European Central Bank has already indicated how CO_2 emissions per capita tend to be lower in economies with relatively more equity-funding.

Equity markets also tend to be less accessible in the EU, with generally lower equity supply for European companies compared to their American counterparts. By providing a harmonised framework at European level for equity financing, it could make financing more accessible to all European businesses and further integrate national capital markets, in line with the key objectives of the 2020 communication on a capital markets union.

Lastly, six EU Member States already have a tax allowance on equity in place at national level (Belgium, Cyprus, Italy, Malta, Poland and Portugal). However, these notional interest deduction regimes have different design features (allowance interest rate, calculation of the basis for the allowance, type of anti-tax avoidance measures), which increases compliance costs for businesses active in multiple Member States.

Existing situation

The European Commission's concerns regarding the debt-equity bias in taxation are not entirely new. As part of the proposal for a common corporate tax base (CCTB)[3] in 2016, the European Commission had proposed an 'allowance for growth and investment' (AGI), which would allow increases in company equity to be deductible from their taxable base, subject to certain conditions. No agreement was found on this proposal.[4]

Soft law guidance on notional interest deduction regimes was provided by the EU Code of Conduct Group on Business Taxation in November 2019, listing a number of elements and characteristics, which might indicate that a notional interest deduction regime may be used for abusive tax purposes.

The deductibility of interest payments is not without its limitations. Companies with cross-border operations may use the deductibility of interest as a way to achieve a (very) low tax burden by multiplying the level of debt in group entities located in high-tax jurisdictions via intra-group financing. To counter this type of aggressive tax planning, the Organisation for Economic Co-operation and Development (OECD) adopted an interest limitation rule, as part of Action 4 of the 'base erosion and profit shifting' (BEPS) project. This rule was subsequently implemented in the EU in 2019, through the implementation of the Anti-Tax Avoidance Directive (ATAD), which also included other measures resulting from the BEPS project. The ATAD (Article 4) rule limits the tax deductibility of companies' net borrowing costs (e.g. interest, financial expenses related to derivatives, etc.) up to €3 million or, if higher, to a maximum of 30 % of the taxpayer's taxable earnings before interest, tax, depreciation and amortisation (EBITDA). Member States were required to implement the ATAD interest limitation rule by 31 December 2018.

Parliament's starting position

In a December 2021 report on the impact of national tax reforms on the EU economy (Rapporteur Markus Ferber, EPP, Germany), the Committee on Economic and Monetary Affairs regretted the existing debt-equity bias in taxation, and feared this may incentivise companies to take on excessive debt. A common European approach was deemed 'preferable' to address this issue, and the committee looked forward to the Commission's proposal for a DEBRA. The committee nevertheless stressed that the Commission should undertake a thorough impact assessment and include effective anti-BEPS provisions, to ensure that companies do not use the allowance on equity as a new tool for profit shifting.

Preparation of the proposal

The Commission adopted a communication on Business Taxation for the 21st century on 18 May 2021, committing to address the debt-equity bias in corporate taxation. While the pro-debt bias in taxation has existed for a long time, the Commission considered that the need to act had become more 'pressing' in the post-coronavirus era, when the stock of company debts had increased significantly. The communication announced it would address this through a proposal for a tax allowance on equity, whilst also including measures to ensure that the incentive is not used for tax abusive purposes.

The European Commission launched a public consultation in July 2021, seeking input from businesses, business associations, academics, non-governmental organisations and citizens. The Commission sought information on the causes and consequences related to the tax based debt-equity bias and possible solutions to address these shortcomings. Some 67 responses were received, primarily from companies and business associations. The majority of respondents argued that a DEBRA could be useful to boost companies' investment through equity after the COVID-19 crisis, and believed that the introduction and harmonisation of such an incentive at EU level would be preferable to the status quo, in particular for those companies who operate in more than one Member State.

The European Commission's impact assessment considers different policy options to address the debt-equity bias in taxation, ranging from removing the tax deductibility of payments to introducing an allowance on new equity combined with stricter interest deductibility. The impact assessment estimated the policy options' impact on cost of capital, share of debt-financed total assets, investment, wages and gross domestic product (GDP). Option 5, a combination of an allowance on new equity and an interest deductibility limitation, was considered the preferred option, with positive impacts on investment and GDP, and effective at addressing the debt-equity bias while ensuring near budget neutrality.

The changes the proposal would bring

The proposal applies to all corporate taxpayers (regardless of whether corporate tax is paid in one or more Member States), apart from financial undertakings (Article 3(1)), some of whom are already subject to strict rules to prevent under-equitisation.

The proposed directive is made up of two separate measures: a tax allowance on equity and a limitation to interest deduction.

Allowance on equity

The allowance base would be calculated by looking first at the year-on-year increase in equity (i.e. the difference between equity at the end of the tax year and equity at the end of the previous tax year). Equity is defined as the sum of the company's paid-up capital, share premium accounts,

revaluation reserve and other reserves and profit or loss brought forward (Article 3(6)), in line with Directive 2013/34/EU (Accounting Directive).

Once the year-on-year increase in equity has been established, it is multiplied by a notional interest rate (NIR). The NIR is based on two components: a risk-free interest rate (RFR) with a maturity of ten years and a risk premium. The RFRs are already calculated on a monthly basis by the European Insurance and Occupational Pensions Authority (EIOPA) and are already a key element of the implementation of Directive 2009/138/EC (Solvency II). The risk premium is set at 1 % for large companies. A higher rate of 1.5 % is set for small and medium-sized enterprises (SMEs), as they generally face higher financing costs and experience more difficulties in accessing equity financing. The total amount calculated by multiplying the allowance base with the NIR will be deductible for ten consecutive tax periods[5] from the corporate income tax base.

The yearly allowance cannot be more than 30 % of the taxpayer's EBITDA. If a taxpayer's allowance exceeds this threshold, they may carry forward the excess allowance up to five years. A taxpayer who experiences an increase in equity but who is loss-making (or has low profits) can carry forward the allowance on equity (or that part of the allowance that they have not been able to deduct) to subsequent tax years without time limitation.

To ensure that taxpayers do not abuse the incentive, a series of specific anti-abuse measures is introduced, based on the guidance issued by the Code of Conduct Group in 2019, to ensure that allowances are only granted to those types of equity increases that represent genuine business needs and investments (Article 5).[6]

The six Member States where an allowance on equity is already in place may defer the application of the directive for a maximum of 10 years (Article 6).

Limitation to interest deduction

To address the debt-equity bias from both the equity and the debt side simultaneously, the European Commission proposes to include a new interest deduction limitation rule. Under Article 6 of the proposal, the deductibility of interest will be limited to 85 % of excess borrowing costs (i.e. interest paid minus interest received). This rule will work alongside the ATAD interest limitation rule (Article 4, where the deductibility of interest is limited to €3 million or, if higher, to a maximum 30 % of the taxpayer's EBITDA). Taxpayers will have to calculate both the deduction amount set by Article 6 of this directive and Article 4 of ATAD. Companies will only be able to deduct the lowest amount in a tax year, but would be able to carry the difference forward (reducing tax liability in a future tax period) or back (thereby generating a refund of tax previously paid).

Stakeholder views

PriceWaterhouseCoopers (PwC) expresses its concern regarding the cohesiveness of the 'carrot and stick' approach of the proposal, and notes the interest deduction limitation rule 'seems to be predominantly designed to achieve budget neutrality (...) and less by tax policy principles'. While the proposal aims to support SMEs, PwC notes that such companies are typically not affected by the ATAD interest limitation rule (as the ATAD has a *de minimis* threshold of €3 million), but such companies would be 'directly negatively affected' by the DEBRA's interest limitation rule (as there is no *de minimis* rule in the DEBRA).

The European Banking Federation (EBF) believes that the interest limitation rule at least should be deleted from the DEBRA, as the increase in costs 'will put additional financial pressure on companies already heavily impacted by COVID-19, the war on Ukraine, supply chain disruptions and inflation restrictions'. Moreover, the new interest limitation rule would arrive at a time when 'billions of sustainability and digitalisation related investments must be made (not only but mostly) through bank loans'.

The European Network on Debt and Development (Eurodad) regretted the European Commission's decision to propose a tax allowance on equity, rather than removing the tax deductibility related to debt, noting the DEBRA 'could potentially open up new avenues for corporate tax avoidance'.

Advisory committees

The European Economic and Social Committee (EESC) is preparing an opinion on the DEBRA (rapporteur: Petru Sorin Dandea, Workers – Group II / Romania; co-rapporteur: Krister Andersson, Employers – Group I / Sweden). Previously, the EESC had stated that the inherent bias against equity in the tax system needed to be addressed, highlighting the important role of equity financing for investment in green technology.

National parliaments

The deadline for national parliaments to submit opinions was 2 September 2022.

The Swedish Parliament issued a reasoned opinion in June 2022, noting that the Commission's proposal 'cannot be considered to be compliant with the principle of subsidiarity'. In particular, the opinion states that the DEBRA would limit Sweden's capacity to set its own corporate tax rules, adapted to national conditions. The Swedish Parliament stresses that 'the fundamental principle of tax sovereignty for the member states must be safeguarded in the case of direct taxation'. Furthermore, following the introduction of an interest limitation rule in the ATAD, the Swedish Parliament 'considers that the extent of the distortion between equity and debt may be questioned, as well as the need for further regulation in this area'.

Legislative process

The legislative proposal (COM(2022)0216) was presented on 11 May 2022. It falls under the consultation procedure (2022/0154(CNS)), requiring unanimity in Council, after consulting the European Parliament and the European Economic and Social Committee. In Council, the proposal is being examined within the 'Working Party on Tax Questions (direct taxation)'. In the European Parliament, the proposal has been assigned to the Economic and Monetary Affairs Committee (ECON – rapporteur: Luděk Niedermayer, EPP, Czechia).

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ENDNOTES

[1] This is based on a hypothetical scenario where it is assumed that the average interest rate of debt were 3 %, and 70 % of all debt is serviced by tax deductible interest payments, applying an EU-average corporate income tax rate of 26 %.

[2] In this context, debt is the sum of debt securities, loans and financial derivatives and employee stock options. Only non-financial corporations are considered.

[3] In 2016, the European Commission launched two proposals: a common corporate tax base (CCTB) and a common consolidated corporate tax base (CCCTB). The AGI was part of the former.

[4] The proposals for a CCCTB are due to be withdrawn and replaced by a proposal for Business in Europe - Framework for Income Taxation (BE-FIT) in 2023.

[5] For example, if a company has an increase in equity of 50 to 80 in year x, an allowance will be deducted from its corporate tax base every year for 10 years (until x+9). The rise in equity (80-50 = 30) is then multiplied by the applicable notional interest rate to arrive at the allowance amount.

[6] For example, Article 5(1) notes that the allowance should not calculated based on the increase in equity as a result of 'loans between associated enterprises'. This is to avoid a scenario whereby, in a company group, company X uses its equity increase to grant a loan to related company Y. Subsequently company Y uses the cash to inject equity in related company Z. In this scenario, the company group would be able to multiply the allowance on equity, despite there being only one genuine increase in equity. This exclusion shall not apply if the taxpayer can provide sufficient evidence that the relevant transaction was carried out for valid commercial reasons and did not lead to a double deduction of the allowance on equity.

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