BUSINESSEUROPE

POSITION PAPER

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Debt-Equity Bias Reduction Allowance (DEBRA)

KEY MESSAGES

- We welcome the European Commission's efforts to support equity financing on a more equal footing compared to debt financing, with the aim of increasing investment and improving the resilience of the EU economy.

- We support an allowance on corporate equity. By encouraging equity financing, such an allowance can boost investments and economic growth, and provide alternative sources of finance to (young and innovative) companies.

- Proposals to make equity financed investments more attractive should not come at the expense of debt-financed investments. We are at a time of increased political and economic uncertainty, with interest rates rising and increasing likelihood of a significant economic downturn. But with significant investment required ahead of the digital and green transition, it is of utmost importance that EU companies have access to diversified source of financing without having to implement additional complex tax legislation. We are very concerned that the new interest limitation rule will make these investments more expensive and harm the competitiveness of European companies by introducing a stricter interest deductibility regime compared to others. Thus, we cannot support the proposed drafting of the DEBRA directive whilst a new interest deduction limitation measure remains included.

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DEBT-EQUITY BIAS REDUCTION ALLOWANCE (DEBRA)

Background

On 11 May 2022, the European Commission presented a proposal for a debt-equity bias reduction allowance (DEBRA). According to the Commission, the current debt bias of tax rules, where businesses can deduct interest attached to a debt financing – but not the costs related to equity financing – can incentivize companies to take on debt rather than increase equity to finance their growth. The DEBRA proposal would make new equity tax deductible, with a more favourable rate of deduction proposed for SMEs. The equity allowance would be computed based on the difference between net equity at the end of the current tax year and net equity at the end of the previous tax year, multiplied by a notional interest rate. The allowance on equity is deductible for 10 consecutive tax years, as long as it does not exceed 30% of the taxpayer's taxable income.

On the back of the COVID-19 crisis and on-going economic uncertainty, European companies are faced with important challenges in the digital and green economy. It remains of the utmost importance that EU companies have access to diversified source of financing in order to be able to undertake necessary and innovative investments. An incentive to boost equity financing is also relevant given that the debt-equity bias is likely to be aggravated by the higher corporate tax rates under the proposed EU implementation of the OECD's Pillar Two. The European Commission's proposal for a DEBRA therefore arrives at the right moment. However, in its current form, it is not balanced and likely to disadvantage business overall, given the fact that the balance sheets of most businesses contain only a limited proportion of equity and a larger proportion of debt. In addition, the DEBRA also has to ensure that the deductible allowance does not lead to a low effective tax rate that triggers a top-up tax liability under the OECD's Pillar 2.

An allowance on corporate equity granted through the DEBRA can increase the re-capitalisation of businesses through increased equity, and have a positive impact on investment, employment, wages, economic growth[1] and the EU's overall competitiveness. As the impact assessment rightly acknowledges, by lowering the debt-bias, the DEBRA can also encourage equity investments into new break-through technologies and products, and thus provide more access to finance to young and innovative companies (who usually have too high of a risk-return profile for the banking sector to finance)[2].

In addition to the DEBRA directive, the European Commission is also undertaking an initiative to simplify the withholding tax procedures which can further support businesses' access to finance. We recommend that, in line with these proposed withholding tax

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[1] A DEBRA implemented without budget neutrality, with a MS specific notional interest rate; and a rate top up for SMEs is estimated to increase investment by 0.84% of GDP, increase wages by 0.41% and EU GDP by 0.26%.

[2] The European Investment Bank notes 'green investments are specific in nature. They enhance welfare but are risky for investors.. Hence, the transition is likelier to be financed by risk-taking and risk-absorbing instruments such as equity.' (European Investment Bank Report 2020/2021, Building a Smart and Green Europe in the Covid-19 era)

simplification procedures, the European Commission also undertakes a review of the DEBRA proposal for it to be effective and simpler to implement, and to undertake more similar tax-initiatives to strengthen the Capital Markets Union and the EU's competitiveness.

Allowance For New Corporate Equity

As we noted in our public consultation, whilst underlining that corporate tax revenue only represents a small share of total tax revenue and several studies have noted positive effects of an allowance for equity on employment and wages (thus contributing in the long run to overall tax revenue), we understand that substantial losses in overall revenue should be avoided. The restriction to an allowance only for **new** equity is thus understandable.

Whilst separate tax rules for SMEs and multinational enterprises should generally not be encouraged due to "threshold effects", we believe it is understandable, in this case, that SMEs are granted a higher notional deduction percentage rate in DEBRA to reflect a generally higher interest rate on debt financing. We believe it would be helpful if Member States provide sufficient, clear and ready-made information to SMEs to ensure that these companies are aware of the possibilities and the benefits of the DEBRA.

We also welcome the grandfathering rule offered to the six Member States who already have an allowance on equity in place. It is important that any EU proposal in this field is not restrictive on Member States' ability to apply similar allowances on equity.

With on-going economic uncertainty and the need for a large amount of investment to address digital and green challenges, we encourage Member States to take an allowance on corporate equity forward at EU-level, thus enabling a greater level-playing field for companies across the EU. Should unanimity not be possible at Council-level, we encourage those Member States willing to introduce an allowance on corporate equity at national level to use a common EU-model, together with uniform anti-avoidance rules, as a standard.

We note that Article 4 of the proposed DEBRA directive gives an allowance on incremental equity (the increase of equity) for a ten-year period. This ten-year limitation means that the benefit a company gets through the proposed Notional Interest Deduction (NID) is only partial. We would therefore stress the need for this proposed NID to be revised into a permanent one. This is because, if a company keeps the equity for any period longer than ten years, it loses the benefit of the NID. This means debt with a term of more than ten years (for which every year's interest cost would be deductible) continues to have an advantage over equity.

Also, if a business reduces its capital or makes distributions such that the value of incremental equity is negative in a period, Article 4(3) has the effect of bringing the negative incremental equity value into the scope of tax for the following ten periods. This means the value of the NID may only be temporary, because the value of it will be clawed back when a business makes distributions or reduces its capital below the level at the beginning of the period.

There are sound business reasons why a business might reduce its capital or make distributions beyond a legal obligation. Often it is to provide the return to investors, in the same way a debt provider expects to receive an interest payment as return on investment. A business cannot simply accumulate cash reserves and issue new equity every year to make its investments, or it would not be an attractive prospect to investors. It may also need to consolidate equity through, for example, share buybacks to improve its financial stability and attractiveness to markets.

In theory, a business might keep the equity in a few entities over a longer period of time, but over the lifetime of a business one would expect much of the equity (as defined in the Directive) will be distributed, resulting in the NID being only a temporary benefit.

This allowance and clawback mechanism could also have completely different effects if periods of positive and negative incremental equity occur in different interest rate environments. In a case where the interest rate is very low when receiving the NID and very high when the capital is distributed, a company would face higher interest that is disallowed compared to the advantage received through the NID: as a result, for a business it is on the one hand not predictable whether there is any benefit at all in a NID; on the other hand it is clear that the general interest limitation comes with a serious disadvantage.

Estimate of the Equity Risk Premium

We are concerned with the approach that the proposal takes in arriving at the estimate for the equity risk premium. The choice of such a premium should be based on information provided by credible and independent expertise, and it should not, as the impact assessment asserts, 'be based on a value judgment.'

Such independent assessments generally suggest a current equity risk premium of around 5% for Germany, with possible country risk premium for other Member States. This is clearly well above the 1% used in the DEBRA proposal for large companies, and 1.5% for SMEs. As such, the proposed measure can only be attractive if a higher rate is contemplated.

Whilst we understand finance ministries may be unwilling to fund an allowance based on the full equity risk premium, it would, in our view, be both more transparent and more robust to provide a partial allowance for a properly estimated risk premium, than a full allowance for an unreasonably low risk premium.

Interest limitation rule

We do not share the Commission's working assumption that companies may decide to rely on debt financing for the sole purpose of reducing their tax burden. This does not correspond to the concrete reality of the financing needs and choices made by companies. We would like to remind the Commission that debt financing is more flexible, both in its architecture (e.g. flexible in terms of duration, debt adapts to the investment), its terms of use and in its origination (type of debt and diversified investors). Debt financing and equity financing should therefore be viewed as complementary sources of financing rather than conflicting.

We are very concerned that the limitation on the deduction of financial expenses under the proposed DEBRA directive would penalize companies much more than under the "ATAD1" directive, and when compared to the minor benefit arising from the NID (as set out above, which is also restricted by complex anti-abuse mechanisms). In particular:

- The 85% cap would immediately affect every company's net financial expenses (while the NID would only apply if and to the extent there is a positive variation in equity over a given year). We believe that, against the current backdrop of increasing interest rates aimed at tackling inflation and an increasing likelihood of an economic slowdown, a new interest limitation rule would further jeopardise the European economy.

- No safe harbour for SMEs: unlike the ATAD1 directive, the proposed DEBRA directive does not contain any threshold. The application of the current text of the directive would therefore be extremely penalizing for SMEs as it is expected that their borrowing costs will increase regardless of the fact that the proposed directive is intended to facilitate access to financing for SMEs. We believe a "safe harbour" should therefore be provided for SMEs.

- The proposed DEBRA directive would lead to a permanent loss of deduction of part of the interest expense in a number of cases. Some companies that are not currently affected by the ATAD1 mechanism would be impacted by the proposed DEBRA directive although their level of indebtedness is reasonable.

- The grandfathering rule offered to the six Member States who already have an allowance on equity in place affects existing Interest Limitation Rules in a similar way. This, together with the absence of a group approach, is likely to further increase potential differences between Member States as well as businesses involved.

- There is no safe harbour for the exclusion of long-term infrastructure financing from the interest deductibility limitation rule, as is the case under ATAD 1. The economic balancing of these infrastructure projects implies the deduction of this interest, which is taken into account in determining the remuneration of the operators, which is itself subject to tax. In order not to penalize long-term public infrastructure projects, we call for an exclusion clause similar to that provided for in ATAD 1.

- The overall mechanism under the proposed DEBRA directive is imbalanced: this is because all companies subject to corporate income tax (especially large companies which typically have easier access to debt financing) will end up financing a more limited set of companies that are able to apply the notional deduction mechanism, depending also on the Member State(s) involved.

- The proposed measure could therefore harm companies facing weaker financial positions and difficulties to attract investors.

- The proposed interest deduction limitation is therefore detrimental to EU businesses as it impacts their competitiveness vis-à-vis non-EU competitors.

Finally, the drafting of the DEBRA proposal appears to be too complex to implement and raises a number of technical issues (for example, there is no clarification on the interaction between the proposed DEBRA directive and the existing ATAD1).

Overall impact of the proposal on investment and growth

The Commission's impact assessment makes clear that a new allowance on corporate equity will increase investment and growth, whilst in contrast a new interest limitation rule would reduce the positive impact of the equity allowance on growth and jobs (an allowance for corporate capital would increase investment by 5.1% of GDP and GDP growth by 1.8% whereas the present proposal which includes a limitation on interest deduction would lead to increased investment and GDP of only 0.26% and 0.018% respectively).

Whilst we understand the pressure on public finances at the present juncture, we believe that the proposed DEBRA directive is a missed opportunity to support increased investment in the economy. The limited allowance will do little to incentivise equity investment, whilst at the same time penalizing those using loans, particularly SMEs. As it stands, the proposal would be a competitive disadvantage for Europe. When compared to the full deductibility of interest payments in other parts of the world, investments in other countries would always be more beneficial than in the EU. A new interest limitation rule could even increase the risk of companies running into bankruptcy if they need to refinance with debt and the deductibility of interest payments is restricted.

The NID as it is currently proposed would provide only a temporary benefit for businesses while the interest limitation would be a permanent disadvantage for businesses. We note, for example, that even under the Commission's conservative estimate of impacts on growth and therefore public finance, the overall directive as presently proposed would increase EU wide total tax revenue from corporation tax by around €10.8 billion.

Now is the time to support business investment, not tax it more heavily. A generous allowance on corporate equity, that better reflects the cost of raising equity, with no change to interest deductibility, can play a decisive role in supporting investment and growth, and provide a more robust base for public finances.