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Euro Tax Flash from KPMG's EU Tax Centre

European Commission proposes a Directive providing for a debt-equity bias reduction allowance

European Commission – Fair taxation – Debt-equity bias – DEBRA - Allowance on equity – Limitation to interest deduction – Anti-tax avoidance

On May 11, 2022, the European Commission issued a proposal for a Directive (the Directive) providing for a debt-equity bias reduction allowance (DEBRA) with the aim to create a level playing field for debt and equity, from a tax perspective, and to help companies build up a solid funding structure.

The proposal would apply to taxpayers that are subject to corporate income tax in an EU Member State and, subject to certain conditions, would provide for a deduction from the tax base of a taxpayer in respect of the increases in its equity in a given tax year. The Directive would further provide for specific anti-abuse measures to ensure that arrangements are not put in place to artificially benefit from the proposed new allowance on equity. In addition, the Directive would introduce a new limitation on interest deductibility, which would need to be applied alongside the interest limitation rules under the EU Anti-Tax Avoidance Directive (Council Directive (EU) 2016/1164 - ATAD).

Background

The European Commission has noted on several occasions that the asymmetric tax treatment of financing costs creates a bias in investment decisions towards debt financing, which hampers efficient capital market financing. In general, tax systems in the EU allow for the deduction of interest payments on debt when calculating the tax base for corporate income tax purposes, while costs related to equity financing, such as dividends, are mostly non-tax deductible.

In the Commission's view, equity investments should be encouraged as companies with a strong capital base are perceived as less vulnerable to shocks. Accordingly, the Commission already started several initiatives in the past to address the issue, including non-tax related initiatives such as the EU's Capital Markets Union 2020 Action Plan (CMU), which aims at promoting equity funding in order for companies to recover from the Covid-19 related economic crisis and become more resilient.

The new DEBRA tax-related initiative was first proposed by the Commission on May 18, 2021, as part of its Communication on Business Taxation for the 21st Century to promote a robust, efficient and fair business tax system in the EU (for more details, please refer to Euro Tax Flash issues 448 and 449). Following its Communication, the Commission published an inception impact assessment and asked for public feedback on possible solutions to mitigate the tax debt-to-equity bias by way of either:

- disallowing the deductibility of interest payments, or
- creating an allowance for equity by enabling the tax deductibility of notional interest for equity, which could be achieved through an allowance for a notional interest deduction on all corporate equity, new corporate equity or corporate capital (equity and debt).

For more details, please refer to E-News issues 135 and 136.

European Commission "DEBRA" proposal

The proposed Directive is structured into four Chapters that set out the rules, starting with general provisions on scope and definitions, moving to the provisions covering the new allowance on equity, anti-abuse measures and a new limitation on the deductibility of interest, and finishing with provisions covering the transposition of the proposed Directive into the local laws of EU Member States.

Scope

The Directive would apply to all undertakings that are subject to corporate income tax in an EU Member State, including EU permanent establishments of non-EU entities. An exclusion would be provided for certain types of financial undertakings (e.g. credit institutions, investments firms, alternative investment funds, insurance undertaking, etc. as defined under EU law) to account for their special features which, according to the preamble of the Directive, would require a specific tax treatment.

Allowance on equity

The Directive would provide for an allowance on equity, which would be computed by multiplying the allowance base (i.e. the increase in net equity in one year) with a notional interest rate:

Allowance on equity = Allowance Base X Notional Interest Rate

with:

- ***equity*** being the sum of paid-up capital, share premium account, revaluation reserve and reserves and profits or losses carried forward;

- ***increase in equity*** being the difference between the net equity at the end of the current tax year and the net equity at the end of the previous tax year;
- ***net equity*** being 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 ***notional interest rate*** would be calculated based on the 10-year risk-free interest rate for the relevant currency, increased by a risk premium of 1 percent or, in the case of SMEs, a risk premium of 1.5 percent. In certain circumstances, the Commission would be empowered to modify the risk premium rate by adopting delegated acts.

The deduction of the allowance on equity would be limited to 30 percent of the taxpayer's earnings before interest, tax, depreciation and amortization (EBITDA) and would be available for ten years, which is seen by the Commission as being approximately the typical maturity of debt. This means that the allowance on equity would be deductible in the year it was incurred and in the following nine years. An additional qualifying increase of equity, e.g. in the following year, would trigger a new allowance on equity, which would also be deductible for the tax year it was incurred and the following nine years since its incurrence.

Where there is a decrease in a taxpayer's equity in a given tax year and where the taxpayer has been subject to an allowance on an equity increase in a previous year, an amount equivalent to the allowance computed previously would be subject to tax for 10 consecutive tax years. This would not apply where the taxpayer provides evidence that the equity decrease exclusively relates to losses incurred during the tax year or to a legal obligation.

In addition, the Directive would provide for carry forward mechanisms where part of the allowance would not be deductible in a certain tax year:

- Where the allowance exceeds 30 percent of the taxpayer's taxable income, the unused allowance may be carried forward for a maximum of five tax years.
- Where the allowance cannot be deducted in a tax period due to insufficient taxable profits, the unused may be carried forward without a time limitation.

Anti-abuse measures

The Directive would further provide for specific anti-abuse measures, which are based on the guidance on notional interest deduction regimes adopted by the Code of Conduct Group in 2019, and would target, in particular, arrangements put in place to artificially benefit from the allowance on equity. Those anti-abuse measures limit the scope of qualifying equity increases by:

- excluding equity increases that originate from (i) intra-group loans, (ii) intra-group transfers of participations or existing business activities and (iii) cash contributions, unless a taxpayer demonstrates valid commercial reasons for those transactions and that the transactions do not lead to a double deduction;
- setting limitations to the calculation of the base of the allowance where equity increases originate from contributions in kind or investments in assets (e.g. to prevent the overvaluation of assets);

- excluding equity increases that originate from converting old capital into new equity, which already existed in the group before a reorganization (e.g. through a liquidation or the creation of start-ups).

Limitation on interest deduction

The Directive would also introduce a new restriction of 15 percent on the deductibility of exceeding borrowing costs (i.e. interest paid minus interest received), in order to address the debt-equity bias simultaneously in respect of both equity and debt and preserves the sustainability of Member States' public finances.

The new interest limitation rule proposed in the Directive would interact with the existing interest limitation rule under Article 4 of ATAD as follows:

- taxpayers would be required to first calculate the deductibility of exceeding borrowing costs under this Directive; and
- then apply the interest limitation rules under ATAD.

The Directive would require Member States to ensure that the taxpayer is entitled to deduct only the lower of the two amounts in a tax year.

In this context, the explanatory memorandum to the Directive provides the example of exceeding borrowing costs of 100, of which 85 percent would be deductible under the proposed Directive, i.e. deduction of in total 85. Where the interest deduction permissible under the ATAD rules is lower (e.g. the permissible amount under ATAD is 80), the additional non-deductible amount (i.e. the difference of 5 in this example) would be carried forward or back in accordance with the provisions of ATAD, as transposed in domestic law of EU Member States. The overall result is that 15 of interest borrowing costs are non-deductible and a further 5 of interest borrowing costs are carried forward or back.

Transposition and transitional rules

The Commission proposes that Member States should transpose the rules into domestic law by December 31, 2023 and that the provisions of the Directive should apply as of January 1, 2024.

The Directive would also provide for transitional rules in respect of those Member States, which currently already apply a tax allowance on equity funding under national law. Those Member States would be allowed to defer the application of the Directive for a period up to 10 years. This period would be limited by the duration of the benefit under national law where the latter is shorter than 10 years.

Next steps

The legislative proposal will now be submitted to the European Parliament for consultation and to the Council for adoption.

Considering that the legal basis for the Commission's proposal is Article 115 of the Treaty on the Functioning of the EU (TFEU), the Directive requires unanimous approval in the Council. In addition, the Council would only be allowed to adopt the text once the Parliament and any relevant Committees have given their (non-binding) opinions.

Where the Directive is approved in the Council, it would enter into force on the twentieth day following that of its publication in the Official Journal of the EU.

EU Tax Centre Comment

The explanatory memorandum to the Directive notes that, in designing its proposal, the Commission took into account the results of the public consultation which was launched on July 1, 2021. Amongst the different policy options, the Commission decided to mitigate the debt-equity bias through measures addressing both equity and debt (as opposed to debt or equity in isolation), combining an allowance for new equity with a limitation to the deductibility of debt costs in order to ensure a sustainable economy and safeguard public finances during the ongoing recovery period after the pandemic.

The successful adoption of this proposal may, however, depend on how Member States' view the impact of DEBRA on their economies (e.g. whether its adoption would be welfare inducing) and on their national budgets (i.e. how much it would cost governments in the short-term). In addition, it remains to be seen whether the six Member States that already provide for an allowance on equity funding in the national law (Belgium, Cyprus, Italy, Malta, Poland and Portugal) would agree to the proposal and to changing their current tax framework. As highlighted in the explanatory memorandum, those national measures currently differ significantly in terms of policy design.

It may therefore be the case that the DEBRA proposal undergoes changes as the political debate develops. It is also anticipated that a public consultation process will be launched by the Commission calling for feedback on the text of the proposed Directive.

It is also noteworthy that the preamble of the Directive makes reference to the proposal for Business in Europe: Framework for Income Taxation (BEFIT). In this respect, the Commission has recently published a consultation page, which mentions that a public consultation on the BEFIT initiative is scheduled to start in the third quarter of 2022 and that adoption is planned for the third quarter in 2023. The BEFIT initiative aims at introducing common rules for determining the corporate tax base and for the allocation of profits between Member States, based on a pre-defined formula (formulary apportionment). The proposal will build on the principles agreed upon under Pillar 1 and Pillar 2 of the OECD BEPS 2.0 proposals, and further adapt these to ensure suitability for an extended use within the EU Single Market. It will therefore be interesting to see how DEBRA interacts with other current tax developments at EU and OECD level including the proposed EU Minimum Tax Directive which is also targeted to be effective in 2024.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

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