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OPINION STATEMENT

Opinion Statement FC 6/2022 on the European Commission Proposal for a Council Directive on debt-equity bias reduction allowance and on limiting the deductibility of interest for corporate income tax purposes ("DEBRA")

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We would be pleased to answer any questions you may have concerning our Opinion Statement. For further information, please contact Bruno Gouthière, Chair of the CFE Fiscal Committee or Aleksandar Ivanovski, Director of Tax Policy at info@taxadviserseurope.org. For further information regarding CFE Tax Advisers Europe please visit our web page http://www.taxadviserseurope.org/

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1. Introduction

CFE Tax Advisers Europe welcomes the work of the European Commission in examining measures through which the Single Market will benefit from better investment and growth, including measures to support long-term and sustainable corporate financing.[1] In doing so, the Commission is looking into possibilities to reduce the asymmetric tax treatment of debt and equity, which it believes may in some cases result in distorted business decisions primarily for tax reasons. The bias towards debt as opposed to equity financing due to the beneficial treatment of interest for taxation purposes does seem more prevalent in the European Union vis-à-vis the United States based companies, although it is not entirely clear whether this is due to tax rules. As a result, highly leveraged European companies could affect the tax base of European states, whereas US companies continue to pull finance through equity, trend likely to continue with the recent rise of interest rates by Federal Reserve and the European Central Bank.

On the overall policy objective of this directive, and the notion that tax rules are causing a bias among European companies to use debt rather than equity financing, CFE makes the following observations:

- For public companies, the true debt/equity position for economic and commercial purposes is driven by the consolidated position, whereas much of the analysis supporting proposals of this nature is based on the debt/equity position of individual countries, whereas the EU proposal if adopted would apply at the level of individual companies. Inter-company debt may be relevant to tax planning (and for that reason is subject in most countries to thin capitalisation and other anti-avoidance rules) but it is completely irrelevant to the true debt/equity position for economic and commercial purposes.

- Similarly for private companies, the true debt/equity position for economic and commercial purposes is dependent not only on the funding of the company but on the debt which the owning entities (individuals/ families) may have incurred personally to finance the business. Lenders may insist on this to get the added security of personal assets; and there may be tax aspects in national tax systems bearing on the taxation of the individuals as well as the company.

- For public companies, the accounting rules (under which debt costs are expensed against profit, and equity costs are generally not), and which operate globally, are likely to be much more influential in determining the debt equity ratio than national tax rules.

[1] Proposal for a Council Directive on laying down rules on a debt-equity bias reduction allowance and on limiting the deductibility of interest for corporate income tax purposes COM(2022) 216 final 2022/0154 (CNS): https://taxation-customs.ec.europa.eu/system/files/2022-05/COM_2022_216_1_EN_ACT_part1_v6.pdf

- There is no general deduction for equity costs in the US tax system any more than in most European countries.

- Companies in any event often have little or no choice as regards whether debt or equity is available in concrete situations such as financing acquisitions.

- Even if tax is a factor, one needs to consider the whole picture including on taxation of equity or debt returns to investors, in trying to design policy to impact the situation.

The proposal as designed might be detrimental to start-ups and pull equity finance away from them. Corporate entities being able to choose between debt and equity funding, would be an incentive to choose more to use equity. It is noted that there is a shortage of equity capital in Europe, as compared to the US, to finance start-ups: if more of the available equity capital is taken by corporate entities/ established companies, there will be even less available for start-ups (introducing a tax incentive for the fund-raising company will do nothing to affect the supply of equity finance from investors).

The DEBRA initiative should go together with an initiative to incentivise individuals to invest more in equity in the EU and also to avoid double economic and juridical taxation on eg. dividends distributed from one Member state to individuals residing in another Member state.

CFE also notes the increasing complexity in the area of EU corporate tax law, including potential overlap between the DEBRA proposals with existing provisions of the ATAD directives, as well as national thin capitalisation rules ("thin cap"). This could lead to further complexity if the interaction of existing measures is not evaluated thoroughly. In addition, with the implementation of Pillar 2, the effective tax rates could be pushed further down by giving another allowance.

2. Specific Comments on EC's DEBRA Proposal

CFE would welcome clarity on the definitions used in the DEBRA proposal in relation to equity and net equity. As opposed to the traditional definition of equity which includes profit and loss of the year, Commission's proposal defines equity as a sum of capital, share premium accounts, revaluation and other reserves and profit and loss brought forward. Clarity would be welcome on the policy reasoning behind excluding profit & loss of the year from the equity definition and calculation.

With respect to the allowance on equity, CFE notes the provisions on allowance of incremental equity for ten years (per Article 4 of the proposed Directive) as means to reduce the cost of equity overall. This provision will reduce the tax base on corporate income tax, which is intended to be offset by interest deduction limitations (per Article 6). Such a policy, which will in turn increase the cost of debt,

could potentially also increase the corporate tax base. From CFE perspective, this analysis is economically driven and might not always result in the desired fiscal outcome from a tax perspective.

Regarding the notional interest rate, which includes the risk-free rate (per EIOPA, for 10 years maturity) in addition to a risk premium of 1% for large firms and 1,5% for SMEs, CFE notes that the risk premium estimates in the draft directive are not adjusted to the market and company's borrowing conditions and they are set without any difference being made for location of a company, which does not reflect economic reality of rates one would pay in the country. For instance, if a company has a 10-year risk free interest rate – the rate used should be the rate of bonds issued in the market, using market reference as opposed to government/ EIOPA reference. As a result, this should be a market- based and company-adjusted rate based on what companies pay when they borrow money. Additional elements might be added to the calculation of the risk premium, such as the credit rating of the company.

The additional credit risk premium would depend on the credit rating of the borrowing person (taxpayer). For individual credit ratings that are published using the Standard & Poor's methodology or another similar methodology the additional risk premium could depend on the rating, for example (1) 0,05% from AAA to A-, (2) 0,20% from BBB+ to B-, (3) 2% below B-, (4) 1% if the taxpayer (borrower) does not have a credit rating. If the taxpayer (borrower) does not have their own credit rating and belongs to a group of companies, it may use the credit rating of the group.[2]

Regarding the interaction with ATAD, CFE notes that if the tax deductible under ATAD is lower compared to 85%, Article 4 ATAD (deductibility) would apply to the difference between these amounts per Article 6 ATAD. Whereas DEBRA would apply to 85% of interest limitation to all companies, Article 4 ATAD would apply as an anti-abuse rule to a limited number of companies, given the scope and divergent implementation in Member states. Furthermore, the limitation of exceeding borrowing costs under Article 4 ATAD would be calculated on the net borrowing costs remaining after the application of the 85% of the ILR.

CFE also notes the inclusion of the anti-abuse framework per Article 5 based on the notional interest deduction regimes used by the Commission in the Code of Conduct Group reference. CFE notes that the lack of clarity of the impact of the anti-abuse provisions (such as those in the example illustrated above) in terms of costs and benefits.

Finally, CFE notes that compatibility issues with primary EU law, in particular with Article 107(1) TFEU and the rules on State aid may arise, given the example of the Belgian Coordination Regimes case[3], where Belgium was required to introduce notional interest deduction (NID) following State aid findings of a preferential nature by DG COMP, European Commission.

[2] For example, the Slovenian safe harbour rule for the tax recognised interest rate.

[3] Judgment of the Court of Justice (Second Chamber) of 22 June 2006 *Kingdom of Belgium* (C-182/03) and *Forum 187 ASBL* (C-217/03) *v Commission of the European Communities.*