EU proposes new Directive on debt-equity bias reduction allowance

On 11 May 2022, the European Commission published a draft Directive proposing to introduce harmonized rules in all EU Member States for a more equal treatment of equity and debt for corporate income tax purposes. Under the proposed Directive, an allowance on equity will be introduced to favor equity investments. Deductibility of interest expenses will however be further restricted. The proposed debt-equity reduction allowance (also referred to as "DEBRA"), if adopted as a Directive, should be transposed into Member States' national law by 31 December 2023 and come into effect as of 1 January 2024.

Background

Tax systems in the EU typically 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 non-tax deductible in most jurisdictions. This asymmetry in tax treatment is one of the factors favoring the use of debt over equity for financing investments, which can lead to undertakings being more vulnerable for unforeseen changes in the business environment.

With a view to addressing this tax-induced debt-equity bias across the European market, this Directive lays down rules to provide, under certain conditions, for the deductibility of notional interest on increases in equity, and to limit the tax deductibility of net interest expenses. The rules set out in the Directive should apply to all undertakings subject to corporate income tax in an EU Member State, except for financial undertakings.

The combined approach of an equity allowance on the one hand and a further limitation on interest deductions on the other, should result in equity and debt financing being treated in a more equally for tax purposes. This should reduce the tax induced bias for debt financing, making the European economy more resilient.

Allowance on equity

The allowance on equity is designed such that increases in a taxpayer's equity, from one tax period to the next, are partially tax deductible. The allowance is computed by multiplying the *allowance base* with the relevant *notional interest rate*.

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

Allowance base: 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; i.e., the year-on-year increase in equity.

Notional Interest Rate: The relevant notional interest rate is the combined percentage of:

(1) the risk-free interest rate: the currency specific risk-free interest rate with a maturity of ten years for the currency of the taxpayer, and

(2) the risk premium: set at 1% or 1.5% for small or medium sized enterprises, to better reflect the higher risk premium they incur to obtain financing.

The allowance is granted for ten years to

approximate the maturity of most debt. This means that if an increase in a taxpayer's equity qualifies for an allowance on equity, the relevant allowance shall be deductible in the year it was incurred and in the next successive nine years.

<u>Limitation</u>

The deductibility of the allowance is limited to a maximum of 30% of the taxpayer's EBITDA (earnings before interest, tax, depreciation and amortization) for each tax year. A taxpayer will be able to carry forward, without time limitation, the part of the allowance on equity that is not deducted in a tax year due to insufficient taxable profit. In addition, the taxpayer will be able to carry forward, for a period of maximum five years, unused allowance capacity, in case the allowance on equity does not reach the aforementioned maximum amount.

<u>Anti-abuse measures</u>

Robust anti-abuse measures aim to ensure that the rules on the deductibility of an allowance on equity are not used for unintended purposes. These anti-abuse measures for example counter contribution of assets in kind, shares and going concern business.

Further limitation on deductibility of interest

On the debt side, the allowance for notional interest on equity is accompanied by a limitation to the tax deductibility of debt-related interest payments.

The deductibility of interest will be limited to 85% of the exceeding net interest expenses (i.e., interest paid minus interest received). Given that interest deduction limitation rules already apply in the EU under Article 4 of the ATAD (the so-called earnings stripping rules), the Directive provides that a taxpayer should:

- first apply the rule from this Directive; and
- then calculate the limitation of the ATAD earnings stripping rules.

If applying the ATAD earnings stripping rule results in a lower deductible amount, the taxpayer will be entitled to carry forward or carry back the difference.

Take away

The Directive is welcomed, as it should have a positive effect on the reduction of the debt / equity bias. Because equity increases will result in a tax benefit and additional interest expenses may not be tax deductible, further thought should be given on how to capitalize businesses going forward, including when to raise new capital. If no allowance is given for equity increases prior to 2024, it could be considered to postpone capital raises to 2024.

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