OPINION

European Economic and Social Committee

Debt-Equity Bias Reduction Allowance

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)]

ECO/595

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Referral	Council of the European Union, 08/06/2022
Legal basis	Article 115 of the Treaty on the Functioning of the European Union
Section responsible	Economic and Monetary Union and Economic and Social Cohesion
Adopted in section	06/10/20022
Adopted at plenary	26/10/2022
Plenary session No	573
Outcome of vote (for/against/abstentions)	187/0/0

1. Conclusions and recommendations

1.1 The Commission proposal on the debt-equity bias reduction allowance (DEBRA) aims to address the tax-induced debt/equity bias for companies in the EU, by implementing rules on the deductibility of the notional interest on increases in equity and by introducing specific limitations to the tax deductibility of net borrowing costs.

1.2 The Commission has to this end developed targeted rules concerning both an allowance on equity and a limitation of interest deductions. Financial undertakings are excluded from the measures, since they are subject to regulatory equity obligations preventing under-equitisation.

1.3 The allowance on equity devised by the Commission is calculated as *Allowance base x Notional Interest Rates*. The allowance base is given by the difference between equity at the end of the tax year and equity at the end of the previous tax year, in other words, the year-on-year change in equity. On the debt side, a proportional restriction will limit the deductibility of interest to 85% of net borrowing costs, meaning interests paid minus interests received.

1.4 The EESC supports the objectives pursued by the Commission, insofar as they are aimed at addressing a relevant and long debated issue in corporate taxation, such as the tax-induced bias in favour of debt over equity. However, the actual structure and content of the proposal are crucial for effectively achieving such objectives.

1.5 In this respect, the EESC deems that the Commission decision to favour equity over debt not only by granting an allowance on the equity capital increased by companies over time, but also by reducing the deductibility of debt weighing on companies by 15%, might harm European businesses, especially SMEs.

1.6 The EESC is concerned that the Commission proposal could make SMEs and micro-businesses, the backbone of the European economy, financially weaker. Such companies do not have easy access to capital markets and, therefore, limiting the deductibility of their interest costs could hamper investment, growth and job creation across Europe.

1.7 The EESC maintains that, in the case of small and micro-enterprises, the encouragement towards equity should be pursued mainly, if not only, by tax allowances on equity without penalising the deductibility of interest on debt.

1.8 The EESC considers the risk premium of 1 to 1.5% contained in the Commission proposal to be both disconnected from the market reality and insufficient to compensate for the loss of interest costs' deductibility. In 2021, the Market Risk Premium (MRP) was above 5 per cent in all Member States and currently remains at those levels.

1.9 The EESC fears that not allowing deduction for legitimate costs of doing business in the form of interest charges might put European companies at a competitive disadvantage compared to businesses in other major trading blocs.

1.10 The EESC notes that disallowing deducibility of interest charges for European companies would create incentives to use leasing arrangements rather than having companies directly investing in machinery and equipment. Furthermore, intragroup financing within large groups of companies in centralized Treasury functions would become more difficult and be undermined making financing of investments more costly, resulting in less investments.

1.11 In order to make a constructive contribution and to fully voice its concerns, the EESC therefore suggests that the Commission substantially reconsider its proposal, including a total or partial exemption from the limitations to debt interest deductibility especially in favour of SMEs and micro-enterprises.

2. Commission proposal

2.1 The Commission Directive's proposal[1] DEBRA aims at addressing the tax-induced debt/equity bias for companies in the EU by providing rules concerning the deductibility of the notional interest on increases in equity and by introducing specific limitations to the tax deductibility of net borrowing costs.

2.2 The proposal is in line with the Commission Communication *Business Taxation for the 21st Century*[2], which singles out the pro debt bias of tax rules as a relevant issue to be tackled by the European institutions to achieve a fair and efficient tax system.

2.3 In its Communication, the Commission points out that a company can currently "deduct interests attached to a debt financing, but not the costs related to an equity financing, such as the payment of dividends, thus incentivising it to finance investments through debt rather than equity. This can contribute to an excessive accumulation of debts, with possible negative spill-over effects for the EU as a whole, should some countries face high waves of insolvency. The debt bias also penalises the financing of innovation through equity".

2.4 The Commission proposal also follows a specific request by the European Parliament to deal with the debt/equity bias ensuring, at the same time, effective anti-avoidance provisions to prevent any allowance on equity being used as a new tool for base erosion[3].

2.5 The Commission proposal has been preceded by an extensive consultation, in which stakeholders, ranging from academics to public authorities, NGOs, business associations and companies, participated. The consultation showed an overwhelming majority of stakeholders maintaining that an initiative to reduce the bias toward debt over equity was necessary.

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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, European Commission

2 Communication from The Commission to the European Parliament and the Council, *Business Taxation for the 21st Century*, COM(2021) 251 final, European Commission

3 *Report on the impact of national tax reforms on the EU economy*, (2021/2074(INI)), European Parliament

2.6 The Commission has also worked with the six Member States that have already implemented rules on the debt/equity bias in order to gather specific expertise on the functioning of such rules based on their first-hand experience[4].

2.7 Developing its proposal, the Commission has considered five possible regulatory options: i) option 1: introducing an allowance on the stocks of corporate equity indefinitely; ii) option 2: introducing an allowance but only for new equity and for ten years; iii) option 3: introducing an allowance on corporate capital, while disallowing current deductibility of interest payments; iv) option 4: disallowing completely the deductibility of interest expenses; v) option 5: developing an allowance for notional interest on new corporate equity for ten years with a partial limitation of tax deductibility on debt for all companies.

2.8 Option 5 has been singled out as the preferable one and, therefore, targeted rules concerning both an allowance on equity and a limitation of interest deductions on debt have been specifically developed within the Commission proposal. Financial undertakings are explicitly excluded by the measures, since they are already bound by regulatory equity obligations preventing under-equitisation.

2.9 More specifically, the allowance on equity devised by the Commission proposal is computed as follows: Allowance base x Notional Interest Rates. In its turn, 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, that is the year-on-year increase in equity.

2.10 In case the allowance base of a taxpayer already benefiting from an allowance on equity is negative in a given tax period (equity decrease), a proportionate amount will become taxable for ten consecutive tax periods and up to the total increase of net equity for which the allowance has been obtained, unless the taxpayer can provide evidence that this is linked to losses incurred during the tax period or due to a legal obligation.

2.11 The proposal sets forth specific rules on the relevant notional interest to be applied and, considering their difficulties in accessing financing, provides for the application of the higher rate in favour of SMEs, without the possibility of derogations by Member States. In order to prevent abuses, the deductibility of the allowance is already, through the BEPS project and EU implementation through the ATAD Directive[5], limited to a maximum of 30% of the taxpayer EBITDA[6] for each tax year. Coordination of the two limitations is proposed.

2.12 On the debt side, a proportional restriction will limit the deductibility of interest to 85% of net borrowing costs, meaning interests paid minus interests received. According to the Commission,

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4 Member States that have rules in place providing for an allowance on equity increases may defer the application of the provisions of this directive for the duration of rights already established under domestic rules (grandfathering)Taxpayers that, on [1 January 2024] benefit from an allowance on equity , under domestic law (in Belgium, Cyprus, Italy, Malta, Poland and Portugal) will be able to continue to benefit from such allowance under national law for a period of up to 10 years.

5 Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market

6 EBITDA: earnings before interest, taxes, depreciation, and amortization

this approach makes it possible to address the debt equity bias working, at the same time, from both the equity and debt side. No equity increases due to intercompany transactions or revaluations of assets are however included.

2.13 The legal ground of the proposal is Article 115 TFEU on the measures of approximation in the form of a directive and the Commission considers the directive proposal in line with the proportionality and subsidiarity principles. The transposition deadline is set for the beginning of 2024, while Member States with rules on the debt equity bias already in place will be allowed to keep the allowances currently in place for the remaining duration of such allowances under domestic law and with a maximum permitted period of ten years.

3. General Comments

3.1 The EESC supports the objectives pursued by the Commission proposal, since they are aimed at addressing a relevant and long-debated issue in corporate taxation, such as the tax-induced bias in favour of debt over equity. The EESC believes that European companies of all sizes might greatly benefit from appropriate and soundly devised rules in this respect, bringing more competitiveness to the internal market.

3.2 The EESC recalls its opinion *The role of corporate taxes in corporate governance*[7], which urged a solution to the debt-equity bias, underlining the risks related to undue leverage and pointing out that "the debt/equity bias in the corporate tax systems affects socio-economic costs, as well as firms' leverage and corporate governance"[8].

The EESC has also highlighted the contribution that addressing the debt/equity bias could bring to the ambitious Commission agenda of making the European economy more sustainable and more digitalised[9], noting that "excessive reliance on debt financing can undermine the achievement of the European Commission's objectives as companies become financially vulnerable, and the possibility of undertaking new, risky green and digital investment projects will be adversely affected". However, the rules to be applied must properly address the DEBRA issue. In particular, the Committee believes that the proposals put forward by the Commission would harm SMEs and especially micro-businesses, making them financially weaker.

3.3 A limitation on the deductibility of interest costs hampers investment, growth and job creation. Such adverse outcomes are even more likely in the current economic situation with interest rate increases.

3.4 The EESC notes that an EU action is preferable compared to several uncoordinated initiatives by Member States. Nevertheless, since six Member States are already applying domestic rules concerning allowances on equity financing, it is worth noting that the net effect of allowance for

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7 OJ C 152, 6.4.2022, p. 13.

8 OJ C 152, 6.4.2022, p. 13, points 4.1 to 4.7.

9 OJ C 152, 6.4.2022, p. 13.

equity and disallowance of interest costs will not fully harmonize investment costs across the EU, even in case of approval of the directive's hereby examined.

3.5 The EESC appreciates the broad and detailed consultation opened by the Commission on the DEBRA proposal, which has given many different stakeholders – business associations, companies, public authorities and academics – the opportunity to voice their positions on a crucial matter for corporate taxation and corporate governance in the EU.

3.6 The EESC also values the targeted consultation the Commission has performed alongside the six Member States which have already approved rules on the debt/equity bias, since it allows the regulator to consider the experience already gained in the field by the national legislators and tax authorities.

4. Specific comments

4.1 The EESC deems that the Commission decision to favour equity over debt not only by granting an allowance on the equity capital increased by companies over time, but also by reducing the deductibility of debt weighing on companies by 15%, will harm European businesses and especially SMEs and micro enterprises. For such companies, the encouragement towards equity should indeed be pursued mainly, if not only, by tax allowances on equity without penalising the deductibility of interest on debt.

4.2 The EESC considers it risky to limit the deductibility of the interest on debt, especially for SMEs and micro-enterprises, in the current economic scenario, which is characterised by the double adverse influence of sustained inflation coupled with rising interest rates implemented by central banks to keep inflation under control. Debt levels have furthermore increased in many businesses during the pandemic. A limitation on tax deductibility could indeed make debts weighing on small and micro-companies more difficult to manage.

4.3 The EESC observes that the proportionality principle as developed by the Court of Justice would require the European institutions to develop rules fit to achieve the regulatory objectives pursued with the least possible sacrifice on the regulated subjects. As to this matter, the EESC points out that a substantial reduction of deductibility for debt-financing could trigger unintended consequences on SMEs, and especially micro enterprises, such as a weakened sustainability of corporate debts, layoffs and overall loss of financial stability across the internal market.

4.4 The EESC notes that disallowing deducibility of interest charges would create incentives to use leasing arrangements rather that companies investing in machinery and equipment themselves. This is not a suitable incentive to introduce, at least not without a thorough analysis.

4.5 Many companies use intra group financing and centralised Treasury functions in order to finance investments in a cost efficient way. The proposed rules would basically require each company in the group to finance its investments. This will increase financing costs and therefore decrease investments in an unfortunate way. The EESC considers it necessary to address this issue, enabling continued efficient financing of investments.

4.6 The EESC recommends limiting compliance costs for the European enterprises interested in benefiting from the new allowance on equity by achieving a sufficient level of legal certainty and predictability of the new rules in order to prevent uncertainties and interpretative issues, possibly resulting in extended negotiations or even litigations between tax authorities and companies.

4.7 In light of the previous arguments and to put forward a constructive contribution, the EESC therefore suggests a substantial reconsideration of the Commission proposal, including a total or at least partial exemption from the DEBRA rules for SMEs and micro-enterprises.

Brussels, 26 October 2022

Christa Schweng
The president of the European Economic and Social Committee

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