EC Directive proposal for a debt-equity bias reduction allowance

Introduction

On 11 May 2022, the European Commission has published a proposal for a Directive addressing the debt-equity bias across the single market in a coordinated way (the **DEBRA Proposal**). It notably proposes a form of deemed tax relief for equity.

The so-called debt-equity bias is an issue that countries have sought to address individually over the last few years, notably by introducing restrictions on the amount of financing costs that can be relieved from a tax perspective, usually by reference to a percentage of earnings (and this was a key part of the ATAD1 directive). The proposal including two separate measures: (i) allowing a deemed deduction on equity funding and (ii) limiting the deductibility of interest on debt financing instruments.

The proposal applies to all taxpayers that are subject to corporation tax in one or more Member States, except for financial institutions (because these are generally subject to regulatory equity requirements). The aim is that the proposal will become effective as of 1 January 2024.

Allowance on equity

The allowance on equity is annually calculated by multiplying 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 (the **Allowance Base**) with the relevant notional interest rate (the **NIR**):

Allowance on equity = the Allowance Base x the NIR

The *Allowance Base* is equal to 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 (the year-on-year increase in net equity). Net equity is 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 (as defined in the Accounting Directive).

The *NIR* is equal to the 10-years risk-free interest rate for the relevant currency and increased by a risk premium of 1% or 1.5% in case of Small and Medium Enterprises (**SMEs**).

The allowance on equity will be available for 10 consecutive years and, to prevent tax abuse, the allowance is limited to a maximum of 30% of the taxpayer's earnings before interest, tax, depreciation and amortization for each tax year. If the maximum amount is not reached, the taxpayer will be able to carry forward the unused allowance for a period of maximum 5 years. In case of insufficient taxable profits, the carry forward has no time limitation.

'Equity' is defined to include brought forward profit or loss as well as paid up share capital, share premium accounts and revaluation reserve and an increase in equity is not therefore limited to situations where an equity injection is made.

In addition, certain anti-abuse rules are proposed:

- Equity increases from (i) the conversion of intra-group loans into equity, (ii) intra-group transfers of participations or existing business activities or (iii) cash contributions under certain conditions will be excluded from the Allowance Base.
- Specific conditions apply for equity increases from contributions in kind or investments in assets.
- The re-categorisation of "old capital" as "new capital" to qualify as an equity increase for the purpose of the allowance. Such re-categorisation could be achieved through a liquidation and the creation of start-ups.

Limitation to interest deduction

In addition, the DEBRA Proposal includes a new interest deduction limitation rule. This rule will limit the deductibility of interest to 85% of net borrowing costs (i.e. interest paid minus interest received).

Given that interest limitation rules already apply in the EU under the earnings stripping rules of the Anti-Tax Avoidance Directive (**ATAD1**), the proposal provides that the taxpayer will apply the rule under this proposal as a first step and then calculate the limitation under the earnings stripping rules. If the result of applying the earnings stripping rules is a lower deductible amount of interest, the taxpayer will be entitled to carry forward or back the difference in accordance with the earnings stripping rules.

Monitoring and reporting

Member States will have to provide specific data to the European Commission annually in order to allow for the monitoring the implementation and effects of this proposal. This includes the number of taxpayers and SMEs that have benefitted from the allowance on equity, total amount of exceeding borrowing costs, non-deductible exceeding borrowing costs, data on the evolution in the Member State of the debt/equity ratio. Member States will need to report this data within three months following the end of every tax period.

Next steps

Adoption of a Directive requires unanimity between all (27) Member States. The DEBRA Proposal will therefore now be discussed and negotiated by the Member States.

It is yet to be seen whether this draft directive will be backed by all the Member States. It is also not clear whether the UK will follow suit; the UK has wrestled with the issue for some years and may not be willing to adopt measures that may be seen as restricting its attractiveness as a holding company location, particularly following the introduction of its qualifying asset holding company regime.

Once unanimity is achieved, the next step would be the publication of the Directive in the Official Journal of the European Union. The Commission proposes that the Member States shall implement the provisions of the final Directive into their domestic tax laws and regulations ultimately by 31 December 2023 and that they shall apply these provisions from 1 January 2024.

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