TAX LAW

Legal Update

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EU Commission issues a proposal of Directive setting forth rules for a debt-equity bias reduction allowance (DEBRA Directive)

On May 11, 2022, the EU Commission published a proposal for a Directive (the **DEBRA Directive Proposal**), addressing the tax-induced debt-equity bias across EU. The DEBRA Directive Proposal is part of Communication on Business Taxation for the 21st Century to promote a robust, efficient and fair business tax system in the EU.

Introduction

The EU Commission highlights that the asymmetric tax treatment of financing costs (i.e., deduction of interest on debt-related financing *vs* non-deduction of costs of equity financing) leads to a bias in investment decisions towards debt financing.

The tax measures proposed with the DEBRA Directive Proposal aim at allowing EU companies to deduct a notional interest on qualified equity increases, while limiting the deductibility of interest and other financing costs.

In the EU Commission's view, this combined approach may help EU companies to raise the capital they need and improve their equity position, avoiding over-reliance on debt and encouraging the re-equitization of businesses, making EU companies stronger and more resilient to shocks. Equity is also considered particularly important for fast-growing innovative companies in their early stages and for companies that wish to expand globally.

According to the current version of the DEBRA Directive Proposal, the new tax measures apply to all undertakings that are subject to corporate income tax in an EU Member State, including EU permanent establishments of non-EU entities.

The EBRA Directive should not apply to certain financial undertakings, including, in particular, credit institutions, investments firms, AIFs and AIFMs, UCITs and UCITs management companies, insurance and reinsurance undertakings, institutions for occupational retirement provisions, certain pensions institutions and certain connected legal entities, central securities depositories, securitization SPVs[1], insurance holding companies or mixed financial holding companies which are part of an insurance group subject to group supervision, payment and electronic money institutions, crowdfunding service providers, and crypto-asset service providers, etc., all as defined under EU law.

1 Covered by Regulation (EU) No 2017/2402.

Proposed tax measures

1. Tax allowance on equity

A. How much?

Under the DEBRA Directive Proposal, the tax allowance on equity (the **Allowance**) is computed by multiplying the allowance base by the relevant notional interest rate, according to the following formula: ***Allowance on equity = Allowance Base X Notional Interest Rate (NIR)***, where:

(i) the **Allowance Base** is equal to the difference between **Equity** at the end of the fiscal year (**FY**) and Equity at the end of the previous tax year that is the year-on-year increase in Equity. For these purposes: (x) **Equity** mans "*the sum of paid-up capital, share premium account, revaluation reserve and reserves and profits or losses brought forward*"; (y) **Net Equity** means "*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*". This is aimed at preventing cascading the allowance through participations in other participated companies; and

(ii) the **Notional Interest Rate** (**NIR**) is calculated based on the 10-year risk-free interest rate[2] for the relevant currency, increased by a risk premium of 1 percent or, for small-medium enterprises (also **SMEs**), a risk premium of 1.5 percent.

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

B. How long?

The Allowance on equity is granted for ten consecutive years. Therefore, if an increase in a taxpayer's equity qualifies for an allowance on equity under the DEBRA Directive Proposal, the incremental allowance shall be deductible in the year in which the increase of capital occurs (TY) and in the next consecutive nine years (TY+9). If, in the following year (TY+1), a new increase in a taxpayer's equity also qualifies for an allowance on equity, the new Allowance will also be deductible for the tax year in which the increase of capital occurs and in the following nine years (until TY+10).

C. Anti-Abuse rules

The DEBRA Directive Proposal envisages some anti-abuse measures to ensure that the rules on the deductibility of an allowance on equity are not used for unintended purposes.

A first measure imposes each Member State to exclude from the base of the Allowance capital increases deriving from (i) loans granted by associated enterprises[3], (ii) transfers of participations or existing business activities (as going concerns) between associated enterprises and (iii) cash contributions made by persons resident in a non-cooperative Country, unless the taxpayer provides sufficient evidence that the relevant transaction is grounded on sound business reasons and does not lead to a double deduction of the Allowance.

2 The risk-free interest rates should be published by the European Insurance and Occupational Pensions Authority (EIOPA).

3 The definition of associated companies is quite broad, and it includes significant participations in management, capital, or profits of the relevant company, exercised either directly or indirectly and whether individually or jointly with other persons.

A second measure regards increases in equity that originate from certain contributions in kind or investment in an asset, which shall be recognized only to the extent the asset is necessary for the performance of the taxpayer's income-generating activity. Shares shall be considered at their book value, while other assets shall be considered at market value (in general).

Lastly, equity increases which result from a reorganization of a group (including, for example, windings-up and the creation of start-ups), which may be regarded as a mere re-labeling of old capital (i.e., equity that already existed in the group before the reorganization) as new capital, should be excluded.

2. Limitation of interest deduction

In parallel with the provisions of an Allowance on equity, the DEBRA Directive Proposal sets forth a new limitation to the deduction of debt-related interest payments. Under the new limitation rule only 85% of the difference between interest expenses and interest income of each FY (**Exceeding Borrowing Costs**) shall be deductible from the corporate tax base of a taxpayer.

The new interest limitation rule would apply in conjunction with the existing ones, laid down by Article 4 of the Council Directive (EU) 2016/1164 of 12 July 2016 (so called **ATAD**). Under the Proposal, the taxpayer shall apply:

a) firstly the 85% threshold; and

b) secondly the limitation applicable in accordance with article 4 of ATAD.

Hence, the maximum amount of deductible interest expenses accrued on each FY will be the 85% of the Exceeding Borrowing Costs. Only that part of such 85% amount which deduction is deferred due to the lack of EBITDA could be carried forward according to the provisions already in force.

Implementation and transitional rules

The legislative proposal will now be submitted to the European Parliament for consultation and to the EU Council for adoption and is, therefore, subject to amendments.

If adopted, the DEBRA Directive should be transposed into domestic laws by 31 December 2023; the new provisions should apply as of 1 January 2024. According to the Proposal, those Member States which already apply a tax allowance on equity under national law (i.e., **Italy**, Belgium, Portugal, Poland, Cyprus and Malta) would be allowed to defer the application of the Directive for a period up to 10 years[4].

Since the DEBRA Directive Proposal would interact with a number of other legislative provisions and EU initiatives (including existing and forecasted anti-abuse provisions, existing allowances on equity, existing interest deduction limitations rules and the much-discussed common rules for determining the corporate tax base and for the allocation of profits between EU Member States), taxpayers should carefully monitor the progress of the proposed Directive.

4 Limited by the duration of the benefit under national law where the latter is shorter than 10 years.

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