AmCham EU
SPEAKING FOR AMERICAN BUSINESS IN EUROPE

Consultation response

Feedback on the debt-equity bias reduction allowance directive

American Chamber of Commerce to the European Union
Speaking for American business in Europe

Avenue des Arts/Kunstlaan 53, 1000 Brussels, Belgium • **T** +32 2 513 68 92
info@amchameu.eu • amchameu.eu • European Transparency Register: 5265780509-97

Executive summary

We support the EU Commission's long-term vision to provide a fair and sustainable business environment and tax system as set out in its 'Communication on Business Taxation for the 21st Century'. As part of this long-term vision, we support the objective to promote a level playing field in tax treatments between equity and debt financing, removing taxation as a factor that can influence companies' funding decisions. Some Member States already provide for such rules in their national legislation and we support the Commission's harmonising role to remove the debt-equity bias across the entire Single Market.

The key to making this reform successful is to ensure that careful consideration is given as to how to fund any tax deductions for equity, noting that such funding does not have to be through limiting interest deductions. It is key to take into account the effects of existing measures, such as the EU Anti-Tax Avoidance Directive (ATAD), which already limits interest deductions. Overly restricting interest deductions go against the overarching policy objectives and would disproportionately impact companies that have more difficulties accessing equity markets, such as small and medium-sized enterprises (SMEs).

Introduction

On 11 May 2022, the European Commission issued a proposal for a Directive on the debt-equity bias reduction allowance (DEBRA). This initiative means to encourage businesses to finance their investments through equity contributions instead of debt financing as a way to reduce over-indebtedness. In order to improve the legislation and ensure that it meets its objective while remaining in accordance with EU constitutional principles – notably proportionality and equal treatment –, it is critical to account for some key considerations.

Overall comments

Whilst we support the idea of allowing companies deductions in relation to equity financing, we do not support the idea of further restricting interest deductions on debt when there are already balanced. Additionally, there are existing interest limitation rules in place across EU countries which follow the implementation of the EU ATAD, as well as local rules which already achieve this aim.

The proposed legislation only allows a deduction for 85% of interest expenses exceeding interest income, and permanently disallows the balance of 15%. This conflicts with the proportionality principle when paired with the ATAD rules that manage interest limitations following base erosion and profit shifting (BEPS). Further, it is not clear how the 85% allowance has been determined and whether this is supported by underlying economic analysis. This is overburdening where the debt is in place for genuine commercial reasons or finance mid/long term investment.

It seems likely that the European economy is heading into a period of sustained inflation, uncertainty and turbulence. Many businesses face uncertain times and may need to access debt to manage their cash flow on a short-term basis. In light of this, limiting interest deductions during difficult trading conditions does not seem appropriate.

Debt provides companies with quick access to finance. It provides greater flexibility to move cash within the group and quickly adjust working capital depending on business cycles and seasonal aspect of business activity, which are not consistent across the year. The decision to raise debt rather than additional equity is governed primarily by business requirements.

Equity, in contrast, is difficult to quickly adjust for liquidity needs and can often only be accessed much slower and to a limited extent than that of debt. In addition, there are often legal, accounting and other commercial hurdles to return equity to shareholders. For example, in several countries it is only possible to legally distribute equity within distributable reserve limits and there is often a requirement to have recently audited statutory financial statements before a dividend can be distributed. This creates a greater burden than debt, for example through the creation of interim financial statements exclusively to that purpose. Therefore, equity may be a more unattractive option for pure treasury and cash flow purposes. In addition, reinforcing equity can incidentally also penalise profit sharing schemes, thereby penalising employees' additional sources of income in an inflation-driven environment.

The proposed Directive requires tracing of equity and intragroup debt balances over several years, as well as annual losses and changes as a result of restructuring and reorganisation, which creates a considerable compliance burden to calculate the additions and subtractions to equity for every entity that is subject to these rules. We would welcome simplifications in this area and the removal of tracing requirements.

Many companies use a mix of debt and equity responsibly in line with their commercial needs, and they keep debt levels within sufficiently low debt-equity ratios. We would therefore welcome more targeted measures to ensure that the proposal does not indiscriminately overburden those companies.

Specific comments on provisions within Directive

There is a benefit for increasing equity that is calculated on a very low rate of a risk free return plus a premium 1% (or 1.5% for SMEs). Depending on how interest rates move in the future, this would not be an adequate substitute for a 10 year loan rate, and it is not clear if and how the premium would flex in future years. The rate of the notional interest deduction should be periodically flexed based on the European Central Bank's rates.

Further restrictions on interest deductibility on debt do not appear to take into account whether debt is third party or intragroup. This does not seem proportionate, given that third party debt should already be on arm's length terms, and therefore there would not be a valid policy rationale to restrict interest deductibility on such debt. Capital-intensive long-term projects such as large infrastructural projects or energy transition require the need for third party debt and access to capital markets to be able to execute these projects.

In many EU countries, for local generally accepted accounting principles (GAAP) purposes, expenses on finance leases are treated as 'interest' (in contrast to operating leases where expenses are treated as 'other operating expenses'). We would recommend that the rules on interest deductibility for debt exclude leases, as this could be a barrier for taxpayers to enter into standard business/commercial arrangements.

When loans are obtained in situations where tax rate arbitrage intent is unlikely, for example where borrower vs lender jurisdiction corporate income tax rate differences are small, we recommend that there is a safe harbour included where the statutory corporate income tax rate of the lender/borrower countries are within 20% of each other.

The allowance on equity is limited to 30% of earnings before interest, taxes, depreciation and amortisation (EBITDA), and there are also interest limitation rules in place following ATAD that are EBITDA-based. It would be helpful to confirm that these are two separate tests, and that the equity allowance does not need to be aggregated with interest expenses on debt for the purposes of applying these rules. To simplify compliance requirements for groups, we would strongly recommend that the basis for the 30% EBITDA test for the allowance on equity be very simple (eg 30% of EBITDA per local GAAP financial statements). Having different calculation methods for different countries (as is already the case today for ATAD rules that are in place) would be unduly complex and burdensome.

Conclusion

We support the EU Commission's long-term vision to provide a fair and sustainable business environment and tax system, as well as the objective to harmonise across Member States the debt-equity bias. The debt-equity bias reduction allowance means to stabilise the financial system by preventing over-indebtedness, but to make this reform successful policymakers must consider how to fund any tax deductions for equity, noting that such funding does not have to be through limiting interest deductions. Overly restricting interest deductions could be extremely harmful for companies, specially in times of uncertainty, inflation and turbulence.