European Union: European Commission proposes a Debt/Equity Bias Reduction Allowance (DEBRA) Council Directive on laying down rules on DEBRA and limiting the deductibility of interest

Proposal for a Council Directive on laying down rules on DEBRA and limiting the deductibility of interest

In brief

On May 11, 2022, the European Commission ("**Commission**") published a proposal for a Directive to address the asymmetry in tax treatment between debt financing and equity financing by creating a Debt Equity Bias Reduction Allowance ("**DEBRA**"). The proposal for a Directive follows the initial announcement of this initiative on 18 May 2021.

The DEBRA rules consists of the following two measures:

- an allowance on the deduction for tax purposes of notional interest on equity ("**allowance on equity**"); and
- a limitation on the tax deductibility of borrowing costs ("**interest deduction**").

The measures apply to all taxpayers that are subject to corporate income tax ("**CIT**") in one or more Member States.

Once adopted, the proposed Directive should enter into force on 1 January 2024. The DEBRA rules should therefore be implemented into the national law of all European Union ("**EU**") member states before 31 December 2023. However, as the proposal for a Directive is a tax measure, which requires unanimous consent, the EU Member States first need to reach agreement on the proposed Directive.

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Key takeaways

- An allowance on equity is proposed, which consists of the **allowance base** multiplied by the **notional interest rate**;
- Deductibility of the allowance is limited to 30% of the taxpayers EBITDA;
- The allowance will be deductible for 10 consecutive tax periods;
- Anti-abuse measures are included in the proposed Directive regarding the origin of any equity increase. These anti-abuse provisions are included to ensure that companies do not increase their equity to achieve a higher allowance on equity;
- The limitation on interest deductions limits the deductibility of interest to only 85% of the exceeding borrowing costs (i.e. interest paid minus the interest received);

- The introduction of the limitation on interest deduction under the DEBRA-rules, does not impact the existing interest deduction limitations under ATAD 1. After the application of the DEBRA-rules, the interest deduction limitation under ATAD 1 should still be applied;
- The proposed Directive is still subject to feedback, so it is not certain yet what the final form of the DEBRA rules will look like. However, once adopted, the allowance on equity and the limitation on interest deduction will affect every taxpayer in the EU.

Background

On May 18, 2021, the Commission adopted a Communication on Business Taxation for the 21st Century. The Communication on Business Taxation outlines the short and long-term vision to support Europe's recovery from the COVID-19 pandemic.

In the same spirit, the EU Action Plan aims to help companies raise the capital they need and aims to improve their asset position, particularly in a recovery period that will bring higher deficits and debt levels, as well as a greater need for equity investments.

In the Communication on Business Taxation the Commission noted that, within European corporate tax systems, debt financing is generally preferred because the related interest payments on debt [from third parties] are deductible as operating expenses. In contrast, costs associated with equity financing, such as dividend payments, are not deductible. This leads to asymmetry in tax treatment, favouring the use of debt over the use of equity to finance investments.

The EU Member States Belgium, Cyprus, Italy, Malta, Poland and Portugal already have an allowance on equity under domestic law. Taxpayers that benefit from an already existing allowance under domestic law will be able to continue to benefit from that specific allowance for a period up to 10 years. The Commission is seeking to harmonize the equity allowance rules in order to avoid tax planning.

Allowance on equity

The allowance of the deductibility of costs relating to equity consists of the **allowance base** multiplied by the notional interest rate.

- The **allowance base** is the difference between the net equity at the end of the tax year and the net equity at the end of previous tax year.

  The terms equity and net equity are defined in Directive 2013/34/EU (the "Accounting Directive"). Net equity is defined as 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.

  Equity is the sum of Paid-up Capital, Share premium account, Revaluation Reserve and Reserves and Profits or Losses carried forward. Article 3(8) of the proposed Directive sets out what is meant by reserves, including: (*i*) legal reserves, (*ii*) reserves for own shares, (*iii*) reserves in line with the Articles of Association of the entity and (*iv*) other reserves.

- The **notional interest rate** consists of two elements, being (i) the 10-year-risk-free interest rate of the relevant currency increased by (ii) a risk premium set at 1%, but increased to 1,5% in case taxpayers qualify as a small or medium-sized enterprise.

If an increase in equity qualifies for the allowance on equity, the allowance will be deductible for 10 consecutive tax periods, meaning the year in which the allowance incurred (tested year ("**TY**")) and the following nine years (TY+9). In case of an equity decrease at the level of a taxpayer that already benefitted from the allowance on, a proportionate amount (of the equity decrease) will become taxable for 10 consecutive tax periods up to the total increase of equity for which such allowance has been obtained.

The deductibility of the allowance is limited to a maximum of 30% of the EBITDA. The part of the allowance that could not be deducted in a year due to insufficient taxable profit, can be carried forward indefinitely. Unused allowance capacity can be carried forward for a maximum of five years.

Example

Example 1 - Equity increase

Company X is a large company with a net equity of 1200 at the end of fiscal year 2025 (TY). By the end of the previous fiscal year, the net equity was 1000. The TY therefore shows an equity increase of 200 compared to the previous year. The allowance base is therefore set on 200. If the risk free rate is 2%, the notional interest rate becomes 2% + 1% (risk premium) = 3%. The allowance then is 200 x 3% = 6. This allowance will be available for deduction in the years TY up until TY+9.

Example two - Equity decrease

Company X (same company as in Example 1) has a net equity of 1100 in 2026 (TY2). In 2025 the equity was 1200 (see above). The TY show a decrease of 100 compared to the previous year. If the allowance base of a taxpayer that has already benefitted from an allowance on equity under the DEBRA rules is negative (equity decrease), a proportionate amount will become taxable for 10 consecutive years. In this example this entails that 100 x 3% = 3 will be taxable in the years TY2 up until T2+9.

The allowance as od TY2 will thus be 6 - 3 = 3.

This is the case unless the taxpayer provides evidence that the decrease in equity is due to losses incurred during the tax period or due to a legal obligation.

Anti-abuse measures

The DEBRA rules contains a number of anti-abuse measures. The following three anti-abuse measures are included in the proposal for the Directive with regard to allowance on equity:

1. Excluded from the allowance base are increases in equity that originate from:
    - intra-group loans,
    - intra-group transfers or participations or existing business activities and
    - cash contributions under certain conditions;
2. Specific conditions for taking into account increases in equity arising from contributions in kind or investments in assets;
3. Re-categorization of old capital as new capital: in cases of, e.g. internal reorganization, an increase in equity will only be taken into account to the extent that it does not result in converting into new equity the equity that already existed in the group before the reorganization.

Limitation on interest deduction

On the debt side, the allowance for notional interest on equity is accompanied by a limitation to the deductibility of debt-related interest payments. The limitation on interest deduction limits the deductibility of interest to 85% of exceeding borrowing costs (i.e. net interest paid minus interest received). In the proposed Directive there are no threshold or safe-harbour rules included. This entails that *every* EU taxpayer (except for financial undertakings) that is subject to CIT falls within the scope of the DEBRA rules.

There is also an interest limitation rule under article 4 of the EU Anti-Tax Avoidance Directive 1 ("**ATAD 1**"). The taxpayer has to apply the DEBRA rules first and subsequently, calculate the limitation under ATAD 1. If the application of ATAD 1 results in a lower deductible amount, the taxpayer can either carry forward or carry back this amount in accordance with the rules of ATAD 1.

Example

Company Y has paid 1100 interest in fiscal year 2025. In that same year, Company Y received 1000 interest. The exceeding borrowing costs are therefore 1100 - 1000 = 100. Under the DEBRA Directive, the deductibility is reduced to 85% of 100, thus 85. If the deductible amount under ATAD 1 is lower (e.g. 80), the difference in deductibility of 5 (i.e. 85 - 80) can be carried forward or back under the conditions of ATAD 1.

Exceptions

The proposed Directive is not applicable to financial undertakings. The proposed Directive contains a list of excluded financial undertakings, of which the definitions can be found in the EU Directives and Regulations. Examples of excepted financial undertakings are:

- Credit institutions which are undertakings of which the activities see upon taking deposits or other repayable funds from the public and to grant credits for their own account (defined in Article 4(1), point (1), of Regulation (EU) No 575/2013 the European Parliament and of the Council);

- Investment firms which include any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis (defined in Article 4(1), point (1), of Directive 2014/65/EU the European Parliament and of the Council);
- Payment institutions which are legal undertakings that have been granted authorization to provide and execute payment services throughout the EU (as defined in Article 4, point (4), of Directive (EU) 2015/2366 of the European Parliament and of the Council).

Reporting

Within 3 months after the end of each fiscal year, EU member states should provide specific information to the Commission in order to allow monitoring the implementation and effects of the DEBRA rules. For example, the information to be shared by the EU members states includes:

- the number of taxpayers that have benefited from the allowance on equity;
- a percentage of the total number of taxpayers falling within the scope of the proposed Directive;
- the number of SMEs that have benefitted from the allowance in the tax period;
- the total amount of expenditure incurred or tax revenue lost due to the deduction of allowance on equity allocated to the allowance on equity as compared to the national gross domestic product of the EU Member State;
- the total amount of exceeding borrowing costs; and
- the total amount of non-deductible exceeding borrowing costs.

Closing remarks

The Directive is currently open for feedback by the public until 20 July 2022. The summarized feedback will be taken into account in the further consideration of the Directive. Ultimately, it is up to the EU Member States in to unanimously agree to the Directive.

Upon adoption, the proposed Directive will bring material changes to tax legislation in all EU member states, which are relevant for all corporate taxpayers. It is advisable to re-examine your current financing structures and to verify whether changes need to be made.

Our tax policy experts are closely monitoring the developments regarding the Directive and actively contributing to the discussions. We will keep you informed of any new developments. If you have any questions regarding the Directive, or its impact on your operations, or if you need assistance with providing feedback to the Directive please do not hesitate to reach out to us.