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By PwC Deutschland | 18 January 2023

Update: EU Commission proposal to reduce the imbalance in the tax treatment of equity/foreign capital

On 11 May 2022, the European Commission published a draft Directive which is intended to mitigate the tax induced debt-equity bias in corporate investment decisions. Technically, this is to be achieved through, on the one hand, an allowance that provides for the deductibility of notional interest on equity and, on the other, by introducing further restrictions on the deductibility of interest on debt.

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Background

DEBRA (Debt Equity Bias Reduction Allowance) is a proposal from the **Communication Business Taxation for the 21st Century** paper, which the Commission published on 18 May 2021. In this document, the Commission had put forward a legislative proposal for a tax deduction to reduce the imbalance between the tax treatment of treatment of equity and debt.

The proposal is also intended to support the EU's **Capital Markets Union Action Plan** (CMU), which is designed to help businesses raise capital, particularly in the post-pandemic period.

Personal scope

The **Directive** covers taxpayers who are subject to corporate income tax in one or more Member State. In addition, it should also apply to permanent establishments located in one or more Member State, where these PEs are maintained by third country resident companies. Furthermore, the draft contains various exceptions to the scope of its application, in particular, vis-à-vis financial undertakings.

Material scope of the rules on equity deduction

The draft provides for a tax-deductible allowance based upon an increase in "net equity". In the event of a reduction in "net equity", the draft also provides for a tax charge on an amount up to the increase in net equity for which a net equity allowance had previously been obtained. Equity is defined by reference to Directive 2013/34/EU (Accounting Directive) as the sum of paid-up capital, share premium account, reserves, revaluation reserves and profit and loss carried forward. "Net equity" is defined for these purposes as the equity of the taxpayer less the sum of the tax value of its participation in the capital of associated enterprises and of its own shares.

Under the proposal, the deduction for an increase in net equity would be allowed over a period of 10 consecutive tax years and up to the amount of 30% of the respective EBITDA; the taxpayer will be able to carry forward any unused allowance capacity for a period of maximum five years.

Furthermore, a taxpayer will be able to carry forward, without time limitation, the part of the allowance on equity that could not be deducted in a tax year due to insufficient taxable profit.

The allowance on equity is computed by multiplying the allowance base with the relevant notional interest rate.

Allowance on equity = Allowance Base x the Notional Interest Rate (NIR)

The allowance base is 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.

The NIR is a combination of a 10-year risk-free interest rate and a risk premium set at 1% or 1.5% for SMEs.

If the allowance base of a taxpayer, which has already benefitted from the net equity allowance, is negative

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in a given tax period (i.e., an equity decrease), a proportionate amount will become taxable for 10 consecutive tax periods, up to the total increase of net equity for which such allowance has been obtained. However, such a tax liability will not apply if the reduction of the equity is due to losses in the period or a legal obligation to reduce equity.

In order to prevent abuse, increases in net equity arising from intra-group loans or intra-group transfers of shares or business activities will not be recognised. Likewise, increases resulting from cash contributions originating from countries with which no exchange of information has been agreed will be excluded. An exception is made in each case provided that the taxpayer proves to a sufficient extent that the measure is taken for valid economic reasons and does not result in a double deduction of the respective equity allowance.

In addition, a provision is made for contributions in kind and investments in assets, according to which a resulting increase in equity capital can only be taken into account if the asset is necessary for the income-generating activity of the taxpayer. Furthermore, any part of the value of the asset contributed or recorded in the taxpayer's accounting books over its market value should be deducted from the base of the allowance.

Further limitation to interest deduction

The proposal provides for the introduction of a further interest deduction limitation. Under the proposal, interest expenses, to the extent that they exceed interest income (net interest expense), will only be deductible to a maximum of 85%.

This limitation is to be applied in combination with the interest deduction limitation under Art. 4 of the Anti-Tax Avoidance Directive (ATAD). The more far-reaching of the two limitations should ultimately take effect. To the extent that the application of the interest limitation rule under ATAD leads to a higher non-deductible net interest expense, the net interest expense is to be carried forward under the ATAD interest limitation rule. Interest expenses exceeding the 85% limit under Art. 6 DEBRA, on the other hand, are not to be carried forward. Insofar as the ATAD interest limitation rule would allow a higher interest deduction, the restriction of a maximum of 85% applies.

Implementation and application

The draft provides for an implementation of the directive by the Member States by 31 December 2023, so that the regulations will start to apply from the year 2024.

Member States may extend the application of the rules for up to 10 years for taxpayers, who are already benefiting from an equity deduction under national regulations

Update (18 January 2023)

At a meeting of the EU Economic and Financial Affairs Council (ECOFIN) on December 6, 2022, **EU member states decided**, at the proposal of the Czech Presidency, **to postpone deliberations** on the draft directive establishing rules for a debt-equity bias reduction allowance and for limiting the deductibility of

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interest for corporate tax purposes (Debt Equity Bias Reduction Allowance - DEBRA).

According to the German government, the reasons for the postponement are ongoing or pending consultations on other EU tax documents related to DEBRA.

Keywords

debt/equity ratio, equity investment, interest limitation, loan interest