EVERSHEDS SUTHERLAND

The TAX TALK

Introduction to the draft EU directive on DEBRA

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Debt-equity bias reduction allowance (DEBRA)

What is the aim of the new DEBRA?

Background: Tax systems in the EU

- Allowance for deduction of interest payments on debt when calculating the tax base
- Cost related to equity financing (e.g., dividends) are non-tax deductible i.e., less favorable
- ➢ Over-indebtedness could threaten the stability of the financial system and increase the risk of bankruptcies

Aim: Mitigate debt bias

- Encourage companies to finance their investment through equity contributions rather than through debt financing

How: Equity allowance – Interest discrimination

- Allowance for equity-financed new investment
- Limitation of interest deduction

DEBRA - Options

What options are proposed?

Option

1. Tax allowance on the stock of corporate equity *(example: 1% notional interest on corporate equity of 1,000 = 10 tax deductible*
2. Incremental tax allowance on *new* corporate equity *(example 1% notional interest on difference of corporate equity (1,200(t2)-1,000(t1) =) 200 = 2 tax deductible)*
3. Identical notional interest deduction for debt (disallowance) and equity (allowance - like option 1/2) *(example: 100 interest expense incurred non-deductible but 10 notional interest tax deductible)*
4. Full disallowance of deductibility of interest expenses *(example: 100 interest expense incurred non-deductible from tax base)*
5. Combination of incremental tax allowance for *new* corporate equity (see option 2) and partial limitation of tax deductibility of interest expenses *(example: see next slide)*

Preferred Option

DEBRA – Option 5

What are the measures of the preferred option?

Option 5

Allowance on new Equity

Allowance: Allowance base x notional interest rate (granted for 10 years to approx. typical debt maturity)

Allowance base: Equity at end of tax year - equity at end of previous tax year (i.e., increase of equity mainly due to non distributed profits)

Notional Interest Rate: Risk free rate + risk premium 1% (or 1.5% for SMEs)

Example:		
Year	*t*	t-1
Equity	*120*	100
Allowance base	*120-100 = 20*	
Allowance	*20 x notional interest rate*	
This allowance will be available for 10 consecutive years: t, t+1,…t+9.		

Limitation to interest deduction

Deductible: 85% of exceeding borrowing cost (interest paid - interest received)

Due to ATAD **most EU member states already introduced rules limiting the tax effective deduction of exceeding borrowing costs** to a maximum of 30% of the companies' EBITDA or have similar domestic rules in force (Germany, Slovakia, Spain). The **DEBRA proposal considers these existing rules** as shown in the following **example**:

Company A 100 of exceeding borrowing cost

1. *Limitation of deductibility by DEBRA: 100 x 85% = 85 deductible (15 non-deductible)*
2. *Deductibility under existing limitation rule 80% (Non-deductible 20). Additional non-deductible amount of 5 (85-80) would be carried forward or back in accordance with the national limitation rules*

Outcome for company A: 15 (100 - 85) of interest borrowing costs are non-deductible and a further 5 (85 - 80) of interest borrowing cost are carried forward or back

DEBRA – Anti-tax avoidance rules

How is abuse prevented and tax fairness ensured?

Anti-Abuse Measures

Prevent overvaluation of equity: Specific conditions for considering equity increases originating from contributions in kind or investments in assets

Equity allowance limited to 30% of taxpayers EBITDA (rest carried forward)

Exclude new equity from **recategorization** of old capital

Equity increases excluded resulting from (i) intra group loans, (ii) intra-group transfers of participations or existing business activities, (iii) cash contributions under certain conditions

DEBRA – Anti-tax avoidance rules

How is abuse prevented and tax fairness ensured?

Explanatory note on exclusion of equity increases resulting from intra group loans:

Prevent that an equity injection granted to company A located in Member State A is used to grant a loan to a related company B located in Member State B. This is because in such case, company B would also use this money to inject equity in another related company C, located in Member State C. This would lead to multiplying the allowance on equity with only one genuine equity increase at group level.

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DEBRA – Anti-tax avoidance rules

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Examples on the specific conditions for considering equity increases from contributions in kind or investments in assets (not conclusively defined in the proposal):

- The value of an asset and the related costs should not exceed reasonable professional needs
- Any part of the value of the asset contributed or recorded in the taxpayer's accounts over its market value should be deducted from the base of the allowance

Exclude new equity from **recategorization** of old capital

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