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Feedback on the Adopted Act on Debt-Equity Bias Reduction Allowance (DEBRA) - Proposal for a COUNCIL DIRECTIVE on laying down rules on a debt-equity bias reduction allowance and on limiting the deductibility of interest for corporate income tax purposes - COM(2022) 216 final - of 11 May 2022.

Brussels, 29 July 2022

Dear Mr Zuijdendorp,

EBIT's Members[1] thank the European Commission for the opportunity to provide feedback to the Proposal for a Directive on the debt equity bias reduction allowance (DEBRA) (hereafter proposed Directive).

Below are EBIT's Members comments on the proposed Directive. We understand that comments received will be used to feed into the legislative debate and hope they will contribute to enhancing certainty for and trust between taxpayers and tax administrations. Further, these comments should be read in conjunction with EBIT's response to the European Commission's questionnaire as part of its public consultation on DEBRA including the Additional comments to the EBIT response of 7 October 2021.[2]

As indicated in the Additional comments mentioned above, EBIT's Members believe that introducing a coherent allowance system for equity financing amongst EU member states might incentivise the re-equitization of financially vulnerable companies. We further mentioned that the choice between equity and debt is a complex assessment mainly driven by non-tax drivers, it should be looked at from the perspective of both the debtor and investor and consider the higher flexibility of debt offered to both investors and debtors. Unfortunately, none of these suggestions were included in the proposed Directive.

In the following paragraphs, EBIT's Members will briefly discuss:

- Additional interest limitation rule on top of the EBITDA rule under ATAD 1[3]
- Grandfathering of certain notional interest deduction regimes
- Interaction with GloBE rules
- Reversal of the burden of proof - Anti-abuse provisions
- Strengthening of other EU policy initiatives

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[1] EBIT's Members include Airbus Group, BP, Carlyle, Caterpillar, Diageo, GSK, Huawei, International Paper, Johnson and Johnson, JTI, PepsiCo, Pfizer, P&G, Raytheon Technologies, RELX, Schroders, SHV Group and Vattenfall. For more information on EBIT see: www.ebit-businesstax.com

[2] https://www.ebit-businesstax.com/papers/ec-public-consultation-questionnaire-debra-2021.aspx and https://www.ebit-businesstax.com/papers/ebit-additional-comments-ec-questionnaire-debra-2021.aspx

[3] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

- Creation of a level playing field between debt and equity financing
- Agreement at global (OECD) level recommended

The proposed Directive contains an additional interest limitation rule

Under ATAD 1, an interest limitation rule (ILR) was introduced based on the OECD BEPS Action 4. This rule limits the exceeding borrowing costs to 30 percent of the taxpayer's EBITDA. This rule does not apply to exceeding borrowing costs up to EUR 3 000 000 or to fully deduct exceeding borrowing costs if the taxpayer is a standalone entity (equity-escape carve=out). We wish to draw attention to the anticipated adverse effects of the ILR under ATAD 1 combined with the ILR under the proposed Directive.

The ILR under the proposed Directive is motivated by maintaining parity between debt financing and equity financing. A further motivation can be found in the desire to preserve the sustainability of Member States' public finances. The ILR under ATAD 1 is motivated to ensure a fairer tax environment through the coordinated implementation in Member States of key measures against tax avoidance that mostly stemmed from the BEPS actions. Following this, the ILR under the proposed Directive and the ILR under ATAD 1 are said to follow different objectives and should apply in parallel.

The combination of the ILR under ATAD 1 and the ILR under the proposed Directive nevertheless has adverse effects.

Reference can be made to the example given in the narrative under the heading *Limitation of interest deduction* of the proposed Directive. In this example, the result is that 15 (100 - 85) of interest borrowing costs are non-deductible and a further 5 (85 – 80) of interest borrowing costs are carried forward or back. The combined application in parallel of the ILR under ATAD 1 and the ILR under the proposed Directive will in practice leave the EU taxpayer worse off, as the taxpayer would be in a better position if 20 could be carried forward indefinitely. So, the taxpayer loses permanently 15 as a deduction.

Further, for taxpayers who make use of the equity-escape carve-out under ATAD 1, the application of the ILR under the proposed Directive will restrict the amount that can be deducted to 85% of the exceeding borrowing cost. Without the application of the proposed Directive, there will be no restriction. Also, when the group ratio rule is applied with the aim to increase the deductibility of interest beyond 30% of EBITDA, subsidiaries of the group will nevertheless be facing (permanent) non-deductible interest restrictions up to the 15% of the exceeding borrowing costs. When SMEs or businesses have made use of the ILR ATAD 1 carve-outs (for example, de-minimis threshold, long-term infrastructure carve-out, etc.), they will now face a restriction on interest where none was provided for under ATAD 1. Conversely, financial undertakings are carved out from ILR under the proposed Directive but won't benefit from the allowance on equity, while their activity in the EU will be further hampered by the ILR under ATAD 1 because of their lending profiles and the extent to which interest deductibility is factored into arrangements.

It goes without saying that the ILR under the proposed Directive makes the EU less attractive for investors.

If the aim of the proposed Directive is to incentivise institutional investors to make more long-term investments and support re-equitisation in the corporate sector, the swap from debt-financing to interest financing should be self-balancing in principle. Many groups have already altered their financing programmes as a result of ATAD 1 and BEPS Action 4. A further limitation of the interest deductibility is for the time being not necessarily a right way forward.

Grandfathering of existing regimes

According to the narrative of the proposed Directive, six EU Member States (Belgium, Cyprus, Italy, Malta, Poland and Portugal) have some form of notional interest deduction in place. Enterprises in those countries will be able to continue to benefit from the incentive under their domestic law for a period of up to 10 years (and in any way no longer than the duration of the incentive itself). As EBIT has flagged before, introducing a coherent allowance system for equity financing amongst EU Member States might incentivise the re-equitization of financially vulnerable companies.

The proposed Directive indicates in its narrative that through the element of subsidiarity the debt-equity bias in the EU cannot be addressed in a satisfactory and coordinated manner through action undertaken by each Member State while acting on its own. The narrative further explains that the individual Member State actions may create distortions to the function of the internal market and can affect the location of investment in a significant manner. Nevertheless, no evidence or examples on the unsatisfactory approach or on how the internal market can be negatively affected are provided by the Commission.

EBIT's Members welcome the grandfathering of the six regimes introduced under domestic laws of the Member States concerned. We also believe, however, that the six individual regimes do not hamper the functioning of the Single Market. EBIT is convinced that introducing such measures is the primary and discretionary responsibility of the countries concerned. As the narrative of the proposed Directive indicates, guidance for this kind of incentives has been developed by the code of conduct and can be considered a coherent allowance system. We believe it is best left to the individual Member States to organise (or not) such incentives in the manner they see fit for the time being. Through the soft-law mechanism a coherent system is already established.

Consider the interaction with the GloBE rules

EBIT's Members could not find any reference to the GloBE directive[4] in the proposed Directive. It is therefore unclear whether the impact of DEBRA on the GloBE rules has been considered at all, despite the fact that GloBE Model Rules and Commentaries have been established at the level of OECD / IF and a GloBE directive is in an advanced stage.

EBIT's Members urge the Commission to examine the interaction between the GloBE Directive and the proposed Directive and preferably identify and remedy any possible adverse effects.

EBIT's Members already identified such adverse effects. For example, how would the incentive under the proposed Directive be treated under the GloBE directive? In case the incentive under the proposed Directive is not accepted for GloBE purposes, the income for GloBE purposes will be higher than the income for local tax return purposes. This will lead in turn to a lower effective tax rate (ETR) under the GloBE rules. This will also mean that a top- up tax will be due when the ETR falls below the minimum ETR of 15 %, even if the drop in ETR is solely due because of the proposed Directive. As a consequence, the equitisation advantage will be eroded through the GloBE rules. Although the debt restriction to 85% of the exceeding borrowing costs as provided for in the proposed Directive may compensate for this effect (increase of local profit), this may not be the case under all circumstances.

Reversal of the burden of proof - anti-abuse provisions

EBIT's Members notice a remarkable tendency in recent Commission proposals to reverse the burden of proof from the tax authorities to the taxpayers. This is no different in the proposed Directive. As such, the proposed Directive obliges to evidence that a reduction in equity that has benefitted from the DEBRA allowance, is the exclusive result due to losses incurred during the tax period or due to a legal obligation. Again, the proposed Directive puts an additional

[4] Draft Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union

transparency burden on the shoulders of the enterprises concerned.

Also, the proposed Directive provides for an anti-abuse rule that indicates that increases in equity may not be derived from loans between associated enterprises (set at a 25 % participation threshold), a transfer between associated enterprises of participations or of a business activity as a going concern, or a contribution in cash from a person resident for tax purposes in a jurisdiction that does not exchange information with the Member State in which the taxpayer seeks to deduct the allowance on equity. EBIT's Members would understand the extra scrutiny if equity is originating from an intra-group loan, but the approach in the proposed Directive means that intra-group financing is excluded from its ambit. EBIT's Members are convinced that this measure may severely impact the financing needs of, for example start-ups or high-risk enterprises, in areas where third party financing may be difficult to obtain.

Furthermore, the proposed Directive indicates that when a contribution in kind or investment in an asset leads to an increase in assets, appropriate measures shall be taken to ensure that the value of the asset is taken into account only where the asset is necessary for the performance of the taxpayer's income-generating activity. This rule aims at preventing the overvaluation of assets or purchase of luxury goods for the purpose of increasing the allowance.

Where an increase in equity is the result of a reorganisation of a group, the increase shall only be considered only to the extent that it converts the equity that already existed before the reorganisation into new equity. Old capital could thus be recharacterized as new capital through liquidation and or start up of companies.

EBIT's Members consider the anti-abuse provisions as having to evidence the good faith in a bona fide transaction. The proposed Directive appears to omit the fact that for many of the transactions covered under the anti-abuse rules auditor reports or valuation expert reports are needed and available. Hence, EBIT's Members believe it should be up to the tax authorities to evidence that the operations are wholly artificial in line with ECJ rulings. EBIT's Members do not see how the anti-abuse measures are in line with the element of proportionality expressed in the proposed Directive.

It is unclear which other EU policy initiatives would be strengthened

The narrative on the proposed Directive indicates that *it complements a number of other policy initiatives promoted by the Commission in parallel, in the short- and long-term.* Further, the narrative contains a reference to BEFIT. Except for this last reference, it is unclear to EBIT's Members which policy initiatives are complemented.

For EBIT's Members, the measure that will be strengthened in practice will be the ILR under ATAD 1. In the light of the content of the narrative, however, EBIT's Members draw the conclusion that this was not the original intention - at least as it is explained in the narrative - of the proposed Directive.

The proposed Directive does not create a level playing field between equity and debt financing

The proposed Directive aims at tackling the asymmetry in tax treatment between debt financing and equity financing as tax systems allow for the deduction of interest payments, while equity-related payments such as dividends are not considered deductible. EBIT's Members acknowledge this asymmetry and as indicated above, welcome initiatives to create a level playing field between debt and equity financing.

As day-to day-tax practitioners, EBIT's Members do not see how the proposed Directive could create such a level playing field. In our view by adding an extra ILR the asymmetry is turned into a disadvantage for debt financing and the extended transfer pricing legislation applied by some Member States to define the level of debt financing vs equity financing is not considered anymore.

EBIT's Members feel that a level playing field should be created between debt financing and equity financing. The decision of using either debt or equity financing is much dependent on the economic and financial situation and should as much as possible not be influenced by policy considerations strange to the development or the carrying-on of the business.

Agreement at OECD Level is recommended

As previously indicated in this note, the proposed Directive adds a supplementary layer of ILR on top of the EBITDA rule under BEPS Action 4. It will therefore put the EU's economy at a disadvantage vis-à-vis countries that have not introduced additional ILRs. EBIT's Members therefore consider that such initiatives should best be left to the OECD to develop a streamlined, sustainable international approach.

Conclusions

EBIT's Members welcome the principle to address the debt-equity bias, but at the same time consider that the introduction of a coherent system can still be achieved on a country-by-country basis on the basis of available soft law guidance and that no European hard law initiative by means of a directive is needed for the time being. Rather, should it become apparent that such an initiative is needed, we believe that such initiative can best be discussed and developed at OECD level, also considering its possible impact on or co-existence with the GloBE rules. We fear that the proposed Directive will only lead to an additional interest limitation measure making the Single Market less interesting for investors.

Yours sincerely,

European Business Initiative on Taxation – July 2022

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