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www.ebit-businesstax.com

To: TAXUD-UNIT-D1@ec.europa.eu

Additional comments to the EBIT response to the European Commission's questionnaire as part of its public consultation on debt equity bias reduction allowance

Brussels, 7 October 2021

Dear Mr. Zuijdendorp,

EBIT's Members[1] thank the European Commission for the opportunity to provide additional comments to its questionnaire as part of its public consultation on the proposal regarding debt equity bias reduction allowance (DEBRA).

Below are additional comments that are intended to add to the Questionnaire and help put EBIT's responses to it into perspective. The main points addressed here relate to sketching the broader picture regarding funding of entities, issues regarding definitions, our view on the materiality of such debt bias, proliferation of measures, potential negative consequences of DEBRA, creating certainty for and trust between taxpayers and tax administrations, recognition of genuine transactions and remaining questions.

In its Communication on Business Taxation for the 21st Century of 18 May 2021 (COM(2021) 251 final), the European Commission stressed the key role that the EU tax framework has to play in supporting the development of the Capital Markets Union, in particular by removing tax barriers to cross-border investment and addressing the debt bias in corporate taxation. In particular, the European Commission stated that the difference in tax treatment in terms of deductibility between debt and equity financing (so-called debt-equity bias) can contribute to an excessive accumulation of debt for non-financial corporations. The European Commission added that it is concerned that high levels of debt make companies vulnerable to unforeseen changes in the business environment and hence increase their risk of insolvency. The European Commission therefore launched the initiative to introduce an allowance system for equity financing the aim being to mitigate the deemed debt-equity bias thereby reducing overall debt-leverage of companies and supporting the economic recovery from the COVID-19 crisis. The European Commission has outlined that the contemplated proposal on DEBRA will incorporate anti-abuse measures to ensure it is not used for unintended purposes.

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 also believe that the choice between equity and debt is a complex assessment mainly driven by non-tax drivers and should be looked at from the perspective of both the

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

debtor and investor. More precisely, debt is often chosen over equity as it provides much more flexibility for both investors and debtors.

The Questionnaire does not distinguish between equity financing at the level of the parent and subsidiary companies in large groups. High levels of debt at the parent company can enhance investor returns but can make it more vulnerable to insolvency, which is not usually the case at the subsidiary level, with groups facing significant reputational issues if they allow subsidiaries to fail. It is recommended that further consideration be given to establishing whether there is a link between subsidiary level debt and insolvency.

Multinational groups aim to use their available funds as efficiently and flexibly as possible within the group, ensuring that the various group affiliates have access to the necessary funding to finance their operations. In this respect, funding by means of debt has the advantage that the term of the finance can be adapted to the specific financing needs of the debtor and that funds can be more easily repatriated within the group. Financing by means of equity has the disadvantage that these funds are made available for an undefined term and can be subject to registration and other costs. Injecting and repatriating such funds within the group is often a long and burdensome exercise.

From an external investor's perspective, it is important to note that funding by means of debt provides investors more flexibility in relation to risk mitigation (e.g., by including guarantees, covenants, ...) whereas investors bear full risks in the case of equity financing. Also, shareholders often prefer a certain level of debt in order to optimise their return on equity. Furthermore, funding by means of debt avoids a dilution of control for existing shareholders.

EBIT's Members are of the view that the appropriateness of a company's debt level could not be captured by single thresholds as it highly depends on:

i. the sector the company is active in;
ii. the territory it is active in; and/or
iii. the maturity of the business.

As such, we believe that it is not useful to pinpoint a certain debt/equity ratio as the market standard. Whether an entity would be considered as highly leveraged can only be determined on the basis of a factual and economic analysis and should not be determined based on fixed thresholds.

Materiality of deemed debt bias

EBIT's Members believe it is important to somewhat nuance the view of the European Commission on the materiality of the deemed debt bias. Over the past years the impact of the debt bias has already been mitigated as a result of the multitude of interest deduction limitation rules as noted further below. Indeed, interest deduction limitation rules partly align the tax treatment of both debt and equity financing in terms of deductibility. Furthermore, the materiality of the deemed debt bias has been reduced over the past years due to the low (and even negative) interest rate environment. EBIT Members believe it is important that these evolutions are considered in the European Commission's assessment of the need to implement DEBRA.

In the event the European Commission wants to proceed with DEBRA, EBIT's Members feel that such a system should preferably be implemented at the EU level to effectively achieve the objectives put forward by the European Commission in its Communication on Business Taxation for the 21st Century. We believe that a coherent implementation amongst EU member states is key to avoid (harmful) competition and distortions between member states and to avoid any additional administrative burdens and uncertainty for both taxpayers and authorities.

Market conditions also play a key role. The availability of debt and the pressure on businesses' strained or already depleted cash reserves post-COVID may dictate a need to consider alternative types and sources of finance as well as the utilisation of equity and hybrid market instruments. The cost of raising equity or partially equity-based capital can be prohibitive for corporates and this could be reduced through efficiencies and regulatory simplification in the capital raising process. However, a tax allowance (or a deduction for certain deemed remuneration on equity) for equity financing could allow businesses to offer a better return to investors to provide recapitalisation capital, or to address specific sector needs or strategic needs, e.g., where rebuilding capital is required to support a green recovery. This could also be sharpened by assessing the potential for broadening dividend and capital gains tax exemptions to enable qualifying long-term investments to be rolled over, even on a temporary time-limited basis. There are many other ways in which the EU might support the tax allowance for equity, supporting investment funds offering market assistance, etc. Any interest deductions/tax allowances provided for equity financing should be available to multinational groups investing further equity into EU subsidiaries, irrespective of whether additional third-party financing or existing surplus funds at HQ level are utilised. This recognises that the multinational has made the choice to use the funds by way of an injection of equity rather than the alternative of debt financing. Wider tax implications of debt vs equity financing should be considered and analysed such as the differences in withholding taxes, net wealth tax, etc.

There may be a case for considering a potential 'COVID-19 preference security' that attracts a tax allowance, designed with additional eligibility criteria or conditions, for example Environmental, Social and Governance (ESG) eligibility to support Europe's transition to becoming more sustainable. Some market researchers suggest that such an instrument could have broad appeal amongst institutional investors, such as pension funds and insurers, that are seeking debt-type risk profiles but with better returns, provided that they are able to properly assess the risk that they would be taking on board.

The wider impact of any new measures will need to be analysed and modelled such as the impact on cost of capital and therefore valuations.

Existing measures for fighting tax avoidance and/or aggressive tax planning

Considering the potential options to address the debt-equity bias as put forward by the European Commission in the Questionnaire, EBIT Members are concerned that DEBRA would ultimately include an additional interest deduction limitation rule on debt financing, as this might be discouraged further with the introduction of DEBRA. In this respect, we wish to stress that already several anti-tax avoidance measures exist to avoid excessive interest deductions. Indeed, through ATAD, EU member states have implemented the so-called 30% EBITDA-rule which already limits the deductibility of interest expenses and expenses equivalent to interest, irrespective whether this relates to intra-group or third-party expenses. On top of this, many local non deductibility measures (e.g., thin cap rules) still exist amongst EU member states. It should also be noted that over the past years tax authorities have tended to assess and challenge the appropriateness of company debt levels from a transfer pricing perspective. In addition, given that there are already numerous filing requirements it would not be helpful if any new proposals would introduce further administrative burdens on businesses such as requirements to file additional returns/reports with tax authorities.

We note that several other international measures are still under construction, for example, introducing a minimum tax under Pillar II of the OECD / G20 / Inclusive Framework project on the taxation of the digitalisation of the economy. The Income Inclusion Rule (IIR) operates as a sort of CFC rule and the Under-Taxed Payments Rule (UTPR) operates as a means of collecting any remaining difference from the application of the minimum tax rate and against BEPS arising from intra-group payments. Together these measures can also be used against excessive deduction of interest expenses.

Because there are multiple measures tackling excessive interest deductions which have either been implemented only recently (i.e., the full effect of which may not be known in the short term) or are still under development and to be implemented soon, EBIT's Members are concerned that the European Commission may try to incentivise the re-equitization of companies by implementing additional interest disallowance rules.

Potential negative market consequences

EBIT's Members strongly believe that implementing additional interest disallowance rules without looking at their interaction with existing measures would negatively impact the EU as an attractive environment for investments. Considering that the choice to opt for debt financing is often driven by non-tax drivers as outlined in the beginning of this letter, additional interest limitation rules would jeopardise the competitiveness of the EU. Furthermore, this would also create a significant risk of double taxation.

It should also be noted that pushing companies towards equity financing could create additional vulnerability within an intra-group context. Multinational groups would have less opportunity to use their available funds flexibly and efficiently within the group. In particular, they would be less likely to anticipate the need for temporary financing within the group. In addition, pushing companies toward equity financing might create potential mismatches and additional risks for groups with central financing entities. In cases where the proceeds of external debt would mainly be invested in the group by means of equity financing, it might be more difficult to gather the necessary liquidities to finance interest payments and/or reimbursements. However, where additional equity financing is to be made then as noted above, any new tax allowances/deductions should be made available to companies.

Furthermore, using equity rather than debt for intra-group funding may, in some cases, lead to foreign exchange mismatches, which are subject to tax. For example, a non-EU group borrowing externally in EUR to invest in the EU would generally have a 'naturally hedged' foreign exchange (FX) position if that EUR borrowing was on-lent to its EU subsidiaries, which it may not be able to achieve if the funds were invested in the EU subsidiaries as equity. Similarly, an EU group financing entity making loans in foreign currencies may have a net FX exposure if it is equity financed, which it could have 'naturally hedged' if it was debt funded in the same currencies as its assets. In the absence of specific tax rules to allow such FX movements to be disregarded, they may give rise to significant tax volatility.

Creating certainty for and trust between taxpayers and tax administrations

As indicated above, a multitude of measures limiting the deductibility of interest are in place already. A possible additional interest disallowance rule to incentivise financing through equity over debt would come on top of those measures. A proliferation of measures leads to multiple layers of legislation and an increase of uncertainty for taxpayers and tax administrations because of:

i. Conflicting provisions in the different measures, for example different scoping and application conditions;
ii. Absence of streamlining between the countries' unilateral measures; and
iii. Different or conflicting interpretations of the different instruments.

These elements create uncertainty for both taxpayers and tax administrations, which in turn leads to more controversy and disputes.

EBIT's Members believe that an approach to addressing debt bias which ultimately comes down to the disallowance of interest expenses is unlikely to help restore the trust relationship between the taxpayers and tax administrations. The European Commission's Communication on Business Taxation for the 21st Century seems to indicate that the choice of financing by debt instead of equity is merely motivated by tax reasons however without any in-depth assessment of the surrounding economic facts and circumstances. We therefore wish to reiterate as day-to-day practitioners that the use of debt is motivated by many different reasons.

Recognition of genuine debt levels versus excessive debt levels

EBIT's Members believe that it is important that genuine debt levels are not negatively impacted, also given the potential spill-over effects this could have for the Single Market as a whole. Although we are convinced that the existing framework is both adequate and fit for purpose, any additional measure that may be contemplated in this context should specifically relate to wholly abusive/artificial debt levels aimed solely at escaping the tax normally due on domestic profits and should not go beyond what is necessary to achieve that purpose.

Common definition of Equity

EBIT's Members are of the view that a coherent implementation of DEBRA across the EU-27 member states is key in order to avoid (harmful) competition between countries and to achieve the objectives put forward by the European Commission in its Communication on Business Taxation for the 21st Century. Hence, we believe that it is of the utmost importance to agree on a common definition of equity and to take into account differences between local accounting rules and tax rules and differences between tax and accounting principles. We feel that the definition currently put forward by the European Commission in its Questionnaire is rather vague and very much subject to interpretation.

Notional interest rate for equity allowance

Based on the Questionnaire EBIT's Members understand that the notional interest rate would be a floating interest rate consisting of a risk-free interest rate plus a margin. Given the current low interest rate environment where reference rates tend to be negative, we believe that it will be useful that, in the case of negative reference rates, a '0%' floor would be applied. Also, we are of the view that the notional interest rate should align to the largest extent possible with the interest rates that companies would incur on their debt. Hence, we believe it will be useful if the European Commission investigated further whether the credit margin component of the notional interest rate could consider for instance the credit worthiness of the borrower (to the extent possible), average market credit spreads, etc. We believe that it would be useful if the credit margin would be similar amongst countries to ensure a coherent implementation of an equity allowance system amongst EU member states and avoid harmful competition. Differences in market interest rates between countries could mainly be captured by the relevant risk-free rate.

Other outstanding questions

EBIT Members believe that there are still a lot of uncertainties in relation to the scoping and consequences of a potential equity allowance system. For instance, it is currently unclear whether a notional interest deduction at the level of the debtor would trigger a deemed interest receipt at the level of the external investor, or other issues with anti-hybrid rules in the EU or elsewhere. We believe that this would lead to negative tax consequences jeopardising the competitiveness of the EU as a place for investments.

EBIT Members trust that the above additional comments are helpful and are taken into account. EBIT Members are always open to engage in further discussions and consultations on this important subject.

Yours sincerely,

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For further information on EBIT, please contact EBIT's Secretariat via Bob van der Made, Telephone: + 31 6 130 96 296; Email: bob.vandermade@pwc.com).