TAX INCENTIVISATION OF DEBT FINANCING VS. EQUITY FINANCING: PRESENT STATUS AND APPROACHES TO SOLVE THE TAX ASYMMETRY[1]

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Abstract: Historically, the cost of financing business through debt has reduced income tax paid. Financing via new equity has not. This asymmetry has not been without consequences. The high indebtedness and relative undercapitalisation of corporates creates a risk of reduced resilience to economic shocks. Some countries have introduced tax incentivisation of equity, reduced tax incentivisation of debt, or both. In June 2022, the European Commission proposed a harmonised solution: Debt Equity Bias Reduction Allowance (DEBRA). All EU Member States, including the Czech Republic, should provide corporate income tax deduction for equity, whilst further limiting interest deduction, starting 2024.

Keywords: debt financing; equity financing; tax asymmetry; notional interest deduction; notional interest allowance; debt-equity bias reduction allowance; DEBRA

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1. INTRODUCTION

Tax law systems in developed countries have historically treated the cost of financing through debt differently from the cost of equity capital. The origin of this difference lies in the accounting treatment of the financing costs: interest on loan borrowing is an expense and as such is reported via the profit and loss account, and therefore generally affects the income tax base. Traditionally, it is an allowable expense, i.e., an item actually reducing the income tax.

In contrast, the provision of equity capital seemingly does not bear any cost accounted for as an expense affecting the profit and loss account. But there is no such thing as cost-free capital. The provider of capital expects to receive remuneration – a share

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of profit (a dividend), which is the economic equivalent of remuneration for providing debt financing. However, from an accounting point of view, this remuneration is not an expense for the company. As tax legislation has been traditionally linked to accounting rules, it does not regulate the cost of capital in any shape or form, and no tax allowance is recognized for the cost of capital.

This article deals with the consequences of this asymmetry in the tax treatment of debt and equity financing on the economic environment, primarily in the context of the EU single market, and the possible solutions to this interesting tax phenomenon.

The goal of this article is to explore the consequences of this asymmetry in the tax treatment of debt and equity financing on the economic environment, primarily in the context of the EU single market. The hypothesis is that the historical bias towards more favourable tax treatment of debt has had a recognizable effect on the financial decisions of businesses in terms of their debt and capital structure, and the resulting undercapitalisation may have wider economic and social implications. This interesting phenomenon is examined primarily using the research methods of deduction, induction, analysis and synthesis, including also a description and comparison of the existing standalone country approaches and a new harmonised solution put forward by the European Commission.

2. DEBT AND EQUITY FINANCING ASYMMETRIES

2.1 DEBT FINANCING

Debt financing of business activities, i.e., financing in form of a temporary provision of funds by another person against an obligation to return these funds together with a fee for their provision, is a traditional business financing instrument. One of the major advantages of debt financing compared to equity financing is the possibility to deduct, for the purposes of calculating corporate income tax, the fee paid to the financing provider. This deduction has significant economic value in relation to the remuneration for the financing. No equivalent deduction is available for income tax purposes for the remuneration for provided equity capital, in form of payment of profit shares or dividends.

Many corporations therefore find it economically attractive to finance their development with a minimum of equity and the highest possible level of debt financing, which can be provided to them by financial institutions via standard credit financing, by bond or note holders upon the issuance of securities, or by other professional institutions such as factoring and leasing companies. However, owners of corporations themselves can also provide financing through debt rather than through the provision of equity, precisely because of the significant tax advantages of such financing.

An excessive debt burden can significantly reduce a corporation's payable income tax. With cross-border financing, this may result in a virtual shift of profit from the country in which business is carried out to the country in which the creditor is based. This may lead to a fiscally significant reduction in the tax revenue of the country in which the debtor is otherwise successfully doing business. Hence, already during the period between the 1970s to the 1990s, many economically developed countries started to limit the deductibility of excessive debt financing to discourage the low capitalisation of companies. These limitations became known as thin capitalisation rules.[4]

In the last few years, more sophisticated rules limiting the deduction of excessive debt financing costs for income tax purposes have been developed, often coordinated by the Organisation for Economic Cooperation and Development, e.g., under the Action Plan to Combat Base Erosion and Profit Shifting[5] or directly imposed, such as by the EU's supranational legislation, e.g., the Anti-Tax Avoidance Directive (ATAD).[6] These new rules either further restrict the possibility to deduct remuneration for excessive debt financing or, in some cases, tie the deductibility criteria to the tax treatment of this remuneration applied by the counterparty to the debt financing arrangement in another country. At the same time, cooperation between tax administrations has increased through new procedural tools such as the automatic exchange of information reported by financial institutions under the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information[7] or reporting of certain types of cross-border arrangements and structures under the Directive on Mandatory Automatic Exchange of Information in relation to Reportable Cross-Border Arrangements.[8]

In the Czech Republic, corporations encountered new restrictions on the deduction of debt financing costs in 2020, due to the implementation of the European Anti-Tax Avoidance Directive, which also deals with financing provided by unrelated parties. The new regulation introduced, among other things, a maximum interest expense deduction equal to 30% of a company's earnings before interest, taxes, and depreciation (EBITDA) or 80 million Czech crowns, whichever is higher.[9] The concept of determining the maximum deductible financing costs regardless of a company's equity was a significant addition to the Czech tax system, where the thin capitalisation rules previously generally only limited interest deductions exceeding a certain multiple of the debtor's equity.[10]

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4 In Czech tax law, thin capitalisation rules are set out in section 25 w) of the Income Taxes Act, no. 586/1992 Sb., as subsequently amended. They generally limit the deduction of interest on loans provided by related parties to the value of debtor's equity multiplied by four.

5 OECD. *Addressing Base Erosion and Profit Shifting* [online]. Paris: OECD Publishing, 2013 [cit. 2022-06-20]. Available at: https://read.oecd-ilibrary.org/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en#page1.

6 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, subsequently amended by Council Directive (EU) 2017/952 of 29 May 2017 (the "Anti-Tax Avoidance Directive" or "ATAD"). Online available at: https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32016L1164&from=cs and https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32017L0952&qid=1656842723272&from=EN.

7 More information about the automatic exchange of information is available at, e.g., https://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/.

8 Council Directive (EU) 2018/822 of 25 May 2018 amending Directive 2011/16/EU as regards the mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements, ST/7160/2018/INIT. *Official Journal of the European Union* [online]. L 139/1. 5.6.2018 [cit. 2022-06-20]. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2018.139.01.0001.01.ENG&toc=OJ:L:2018:139:TOC.

9 Section 23 e) of the Income Taxes Act, no. 586/1992 Sb., as subsequently amended.

10 Section 25 w) of the Income Taxes Act, no. 586/1992 Sb., as subsequently amended.

The commercial law of most market economy countries imposes very few requirements on a company's registered capital. The amount of equity is often not regulated at all, or only by limiting the company's ability to distribute profits or, indirectly, by requiring the company to deal with an accounting loss. Special rules usually apply to companies incorporated with a public offering of shares, banks, insurance companies, and other regulated entities. Companies seeking to list their shares on a stock exchange may also be subject to stock exchange requirements for their minimum capitalisation.

From a purely economic point of view, the choice as to whether a business should seek corporate financing in the form of capital or debt is primarily influenced by factors such as estimates of future market trends, the duration of planned investments, the composition of assets, financial plans, and tolerance of risk. There is generally no "normal" debt/equity ratio for companies.[11] However, in some sectors we can trace a trend towards a typically similar level of debt burden. To illustrate, below are the debt/equity ratios of several publicly traded companies in the United States:[12]

Sector	**Debt/equity ratio (median)**
software	1.45
pharmaceuticals	11.80
sports goods	34.19
motor vehicles	65.70

Part of the debt financing is provided by the companies' shareholders themselves, in some cases because for regulatory or other reasons they cannot provide capital of their own, but usually because providing credit is more beneficial to the shareholders and the company as a whole.

An economic (non-tax) reason for a higher level of indebtedness of a company is often the legally simpler mechanism for granting debt and obtaining its repayment compared to the provision of capital, the avoidance of stamp or capital duties existing in a number of countries, or the limitation of foreign exchange rate differences.[13] Another important non-tax factor is the measurement of the performance of the investment using the return on capital employed indicator (ROE), which requires the highest possible return on investment per unit of capital employed. Each additional unit of capital provided reduces the performance of the investment.

[11] PILTZ, D. International aspects of thin capitalisation: General Report. In: *Cahiers de droit fiscal international*. *Volume LXXXlb, subject II*. The Hague: Kluwer Law International, 1996, p. 90.

[12] Ibid., p. 91.

[13] A loan can usually be provided in the currency of the creditor's country or another currency. Capital contributions may be limited to the local currency. PILTZ, *c. d.*, p. 92.

2.3 IMPACT OF TAX LEGISLATION ON THE PREFERENCE FOR DEBT OVER EQUITY

However, the most decisive influence affecting the choice of whether a shareholder grants a loan instead of equity capital is usually their different tax treatment. For the recipient of the loan (the borrower), a loan results in an expense generally deductible from the income tax base; for the provider of the loan (lender), the interest is taxed. The provision of equity capital gives rise neither to an expense nor to a tax deduction for the recipient; the provision of equity capital is "rewarded" by the payment of a profit share (dividend), but which is not deductible. The profit share (dividend) received by the recipient is generally subject to tax but may also be tax exempt.[14]

From the point of view of the recipient of credit or equity capital, a preference for credit is clear as it reduces its tax burden.[15] From the combined perspective of the lender and the borrower, a loan is often more advantageous overall, particularly where the income tax rate in the lender's country is lower than the income tax rate in the borrower's country, or where the lender reports tax losses from other activities available to offset against the interest income.[16] Even if the provision of a loan has a neutral overall impact, this option may still be more tax efficient than the provision of capital. Indeed, the exemption of profit shares (dividends) received often has certain negative implications for the provider of equity capital, such as limiting the deduction of interest paid by the equity provider on its own borrowing.

2.4 CONSEQUENCES OF ASYMMETRY IN THE TAX TREATMENT OF DEBT AND CAPITAL

The persistent incentivisation of debt financing due to the more favourable tax treatment of related costs is not without consequences for the overall capital structure of the business sector. According to the European Commission and the OECD,[17] the high indebtedness of corporates and their relative undercapitalisation creates a risk

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[14] In many countries, dividends received are exempt from tax. In Czech tax law, see section 19 ze) of the Income Taxes Act, no. 586/1992 Sb., as subsequently amended.

[15] SOMMERHALDER, R. Approaches to Thin Capitalisation. *European Taxation*. 1996, Vol. 36, No. 3, pp. 92–96.

[16] PILTZ, *c. d.*, p. 97.

[17] E.g., European Commission. Annual Growth Survey 2016: strengthening the recovery and fostering convergence [online]. 26.11.2015 [cit. 2022-06-20]. Available at: https://ec.europa.eu/futurium/en/system/files/ged/ags2016_annual_growth_survey.pdf; OECD. *How to restore a healthy financial sector that supports long-lasting, inclusive growth?* [online]. OECD Economics Department Policy Notes, No. 27. Paris: OECD Publishing, 2015 [cit. 2022-06-20]. Available at: https://www.oecd.org/economy/How-to-restore-a-healthy-financial-sector-that-supports-long-lasting-inclusive-growth.pdf; Financial Stability Board. Corporate Funding Structures and Incentives: final report [online]. Basel, 28.8.2015 [cit. 2022-06-20]. Available at: https://www.fsb.org/wp-content/uploads/Corporate-funding-structures-and-incentives.pdf. Also, European Commission. Action Plan on Building a Capital Markets Union. In: *EUR-Lex: Acces to European Union Law* [online] 30.9.2015 [cit. 2022-06-20]. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52015DC0468; or European Commission: Tax Reforms in EU Members States 2014: tax policy challenges for economic growth and fiscal sustainability. *European Economy* [online]. 2014, No. 6 [cit. 2022-06-20]. Available at: https://ec.europa.eu/economy_finance/publications/european_economy/2014/pdf/ee6_en.pdf.

of reduced resilience to financial market turbulence such as the massive global financial crisis that followed the collapse of Lehman Brothers in 2008. The possible insolvency of firms during an economic crisis and their forced restructuring may then trigger significant social costs in terms of employment.

This topic has become even more relevant over time, especially in view of the pandemic situation of the last two years. In 2020, the total debt of non-financial corporations in the Member States reached almost EUR 15 trillion, representing 111% of the EU's gross domestic product.[18]

Another effect is a reduction in the growth and strength of organised capital exchanges, which are an important part of the capital market, especially for young and innovative companies whose access to debt financing is limited in the early stages of their development (e.g., because of the short history of the company or the absence of sufficient collateral for the loan commitment).

3. TACKLING THE ASYMMETRY

3.1 NON-HARMONISED APPROACH AT STATE LEVEL

In the recent past, some European countries have taken measures to reduce debt-equity financing asymmetries and to promote increased capitalisation of domestic companies. Most of these models have been based on allowing a deduction from a company's tax base of a notional cost of remuneration for providing equity capital as an analogy to the traditional deduction of interest expense for debt financing. The first such country was Belgium in 2006, followed by Portugal in 2008, Italy in 2011 (with a significant temporary increase in the notional deduction rate in 2021), Cyprus in 2015, Malta in 2018, and Poland in 2019.[19]

3.2 BELGIUM[20]

Belgium provides for the possibility of deducting notional interest on capital at the average rate applicable to 10-year government treasury bills in July, August, and September of the year preceding a particular fiscal year. The maximum interest may

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18 Press release by the European Commission dated 11 May 2022 (European Commission. Corporate taxation: Commission proposes tax incentive for equity to help companies grow, become stronger and more resilient. In: *Commission proposes tax incentive for equity* [online]. 11.5.2022 [cit. 2022-06-20]. Available at: https://ec.europa.eu/commission/presscorner/detail/en/IP_22_2884).

19 FLAMANT, E. – GODAR, S. – RICHARD, G. *New Forms of Tax Competition in the European Union: an Empirical Investigation* [online]. EU Tax Observatory, 2021 [cit. 2022-06-21]. Available at: https://www.taxobservatory.eu/wp-content/uploads/2021/11/EU-Tax-Observatory-Report-3-Tax-Competition-November-2021.pdf.

20 CRUYSMANS, G. Corporate Income Tax, Incentives, Notional interest deduction. In: *Belgium – Corporate Taxation sec. 1., Country Tax Guides IBFD* [online]. [cit. 2022-06-21]. Available at: https://research.ibfd.org/#/doc?url=/document/cta_be_s_1.

not exceed 3%, whereas the year-on-year increase or decrease in the interest rate may not exceed 1%. In 2022, the rate is 0%. Small and medium-sized businesses may use a rate of 0.443%.

Previously, the basis for the determination of notional interest was total equity as reported in the accounts at the end of the preceding accounting year. From 2018 onwards, the basis is the increase in net equity over the last five years.

Until 2013, the unused portion of the notional interest deduction could be carried forward to the next seven accounting periods if certain conditions were met. This option was abolished.

Belgian legislation contains several anti-abuse measures specifically aimed at the deduction of notional interest. e.g., no deduction is possible for capital contributions made by related persons if these are financed through a loan on which interest was tax-deductible for the contributor.

3.3 ITALY[21]

Italy permits the deduction of notional interest at a fixed rate of 1.3% of the net equity increase compared to the balance as at 31 December 2010. Profit distributed to shareholders reduces the net capital increase. The basis for calculating notional interest is also reduced by the result of certain intra-group transactions. It is possible to carry forward the deduction of notional interest to future years under certain conditions.

3.4 CYPRUS[22]

Cyprus allows for the deduction of notional interest on fully paid-up registered capital and share premium introduced on or after 1 January 2015. From 2020, the amount of notional interest has been set at the rate of a 10-year government bond issued in the country in which the capital is invested, plus 5%. If the government of that country has not issued a government bond by 31 December of the previous year, the reference rate shall be the Cypriot government bond rate plus 5%. The notional interest deduction shall not exceed 80% of a company's taxable profits (before the deduction of such interest).

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[21] SILVANI, C. Corporate Income Tax, Deductions, Other deductions, Miscellaneous. In: *Italy – Corporate Taxation sec. 1., Country Tax Guides IBFD* [online]. [cit. 2022-06-21]. Available at: https://research.ibfd.org/#/doc?url=/document/cta_it_s_1.

[22] TALIOTIS, A. Corporate Income Tax, Deductions, Other deductions, Notional interest deduction. In: *Cyprus – Corporate Taxation sec. 1., Country Tax Guides IBFD* [online]. [cit. 2022-06-21]. Available at: https://research.ibfd.org/#/doc?url=/document/cta_cy_s_1.

3.5 MALTA[23]

In Malta, a deduction of notional interest is generally available for capital not invested in securities, interest-free loans, and assets with related income exempt from tax.

The interest rate is derived from the rate of long-term Maltese government bonds, plus 5%.

3.6 POLAND[24]

From 1 January 2019, taxpayers in Poland can deduct notional interest from the tax base on capital contributions and retained earnings, except for contributions and retained earnings intended to cover company losses. This is subject to the condition that these capital items will not be refunded or paid out for at least three years. The interest rate is based on the reference rate of the National Bank of Poland at the end of the previous calendar year plus 1%. The deduction may not exceed PLN 250,000 (approx. EUR 53,000).

From 1 January 2021, deductions are disallowed for activities that have no economic justification and whose only motivation is to obtain this deduction for tax purposes.

3.7 PORTUGAL[25]

Small and medium-sized businesses in Portugal are entitled to a deduction of notional interest at a fixed rate of 7% on the capital generated by contributions or the capitalisation of receivables, up to a maximum of EUR 2 million. The capital must not be reduced in the following five years, otherwise the part of the deduction used plus 15% must be taxed.

4. EFFORT BY THE EUROPEAN COMMISSION TOWARDS A HARMONISED SOLUTION

Having identified the risk of instability of the economic environment within the single market resulting from the excessive incentivisation of debt financing,[26] the Europe-

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[23] TORREGIANI, C. Corporate Income Tax, Deductions, Other deductions, Notional Interest Deduction Rules. In: *Malta – Corporate Taxation sec. 1., Country Tax Guides IBFD* [online]. [cit. 2022-06-21]. Available at: https://research.ibfd.org/#/doc?url=/document/cta_mt_s_1.

[24] OLEJNICKA, M. Corporate Income Tax, Deductions, Other deductions, Notional interest. In: *Poland – Corporate Taxation sec. 1., Country Tax Guides IBFD* [online]. [cit. 2022-06-21]. Available at: https://research.ibfd.org/#/doc?url=/document/cta_pl_s_1.

[25] OLIVEIRA EVERAERT, G. J. Corporate Income Tax, Incentives, Incentives under national legislation, Notional deduction for SMEs. In: *Portugal – Corporate Taxation sec. 1., Country Tax Guides IBFD* [online]. [cit. 2022-06-21]. Available at: https://research.ibfd.org/#/doc?url=/document/gtha_pt_s_1.

[26] In Action Plan on Building a Capital Markets Union or the proposal for Common Consolidated Corporate Tax Base, recently in Communication on Business Taxation for the 21st Century dated 18 May 2021 European Commission. Communication on Business Taxation for the 21st Century. In: *Taxation and Customs Union* [online]. 18.5.2021 [cit. 2022-06-20]. Available at: https://ec.europa.eu/taxation_customs

an Commission decided to pursue a harmonised solution. In June 2021, the commission published a draft plan for a future Debt-Equity Bias Reduction Allowance (DEBRA) initiative.[27] The commission pointed to the continuing problem of asymmetry of the regime of debt and equity financing,[28] and the attempt of six Member States to address the matter on a local level.

The European Commission pointed out two principal approaches to the problem of the asymmetry of the tax regime of debt and equity financing. The first – the simplest one – is to disallow any deduction for interest expense on debt financing. This would completely abolish the asymmetry arising from the existing incentivisation of debt financing. The other approach is to allow a deduction for a notional interest representing the economic cost of equity financing as a balancing act.

In the latter approach, notional interest can be computed based on (i) all of the equity financing, (ii) new equity financing, i.e., additions (increases) over the time, or (iii) the whole volume of equity and debt financing, which would enable the introduction of a unified tax deduction combining the debt and equity allowances in one.

The latter approach is similar to the approach already considered in the works on the proposal of the Common Consolidated Corporate Tax Base (CCCTB),[29] where three variants were contemplated: ACE (Allowance of Corporate Equity), AGI (Allowance of Growth and Investment), and ACC (Allowance of Corporate Capital).[30]

4.1 ALLOWANCE OF CORPORATE EQUITY (ACE)

This option involves a deduction from the tax base of an amount corresponding to a defined return on capital, usually set at a risk-free rate, e.g., of State treasury bonds. This perspective does not put the debt and equity financing on an equal

/communication-business-taxation-21st-century_en). For a technical analysis of available solutions, see European Commission, Directorate-General for Taxation and Customs Union – STUTZENBERGER, K. – NICOLAY, K. – SPENGEL, C. et al. *The effects of tax reforms to address the debt-equity bias on the cost of capital and on effective tax rates: final report* [online]. Luxembourg: Publications Office, 2016 [cit. 2022-06-20]. Available at: https://data.europa.eu/doi/10.2778/577384.

27 European Commission. Debt-equity bias reduction allowance (DEBRA) [online]. 14.6.2021 [cit. 2022-06-20]. Available at: https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12995-Debt-equity-bias-reduction-allowance-DEBRA-_en.

28 The Commission referred to the European system of accounts, which defines equity as *"a financial asset that is a claim on the residual value of a corporation, after all other claims have been met"*. The system also points out the difference between debt and equity: *"Raising equity capital through the issue of shares is a way of raising funds. In contrast to loan capital, equity capital does not give rise to a liability that is fixed in monetary terms and does not entitle the holders of shares of a corporation to a fixed or predetermined income."* (European Commission. *European system of accounts: ESA 2010* [online]. Luxembourg: Publications Office of the European Union, 2013 [cit. 2022-06-24]. Available at: https://ec.europa.eu/eurostat/documents/3859598/5925693/KS-02-13-269-EN.PDF/44cd9d01-bc64-40e5-bd40-d17df0c69334).

29 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52016PC0683&qid=1656169973606. This proposal is no longer being pursued and has been replaced with a new initiative BEFIT (Business in Europe: Framework for Income Taxation).

30 European Commission. Impact Assessment accompanying the document Proposals for a Council Directive on a Common Corporate Tax Base and a Common Consolidated Corporate Tax Base (CC(C)TB). In: *EUR--Lex: Acces to European Union Law* [online]. 25.10.2016 [cit. 2022-06-20]. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52016SC0341.

footing as the deduction for the actual cost of debt will always be higher due to the risk premium. This option is usually complemented with anti-avoidance measures to prevent the cascading of the deduction along the ownership structure in an intra-group setting.

4.2 ALLOWANCE OF GROWTH AND INVESTMENT (AGI)

This is a similar option; however, the allowance is not based on a company's equity as a static value but rather on its increase over a defined time period. For example, the basis may be a marginal increase in equity over the period of ten years. Only this new equity then benefits from a notional interest deduction.

4.3 ALLOWANCE OF CORPORATE CAPITAL (ACC)

This option provides a level playing field for debt and equity financing. The interest deduction on debt financing is abandoned as there is only a single deduction based on the total volume of debt and equity. A single rate is applied. Its basis may be either the static value of debt and equity or their increase over a defined time.

The following provides a useful summary of the pros and cons of the three variants of a notional deduction for equity:[31]

Variant	Pros	Cons
ACE	• practical experience (six Member States have unilaterally adopted similar provisions)	• narrower corporate income tax base, resulting in revenues losses for the State budget (unless accompanied by tax rate increase) • potential need to increase corporate income tax rates to compensate revenue loss • delicate balance between potential corporate income tax rate increases and a welfare creation • full financing neutrality for ACE and AGI is achieved only if the rate equals the market interest rate

[31] The summary is based on information provided by the European Commission in document "Impact Assessment Accompanying the document Proposals for a Council Directive on a Common Corporate Tax Base and a Common Consolidated Corporate Tax Base (CCCTB)", dated 25 October 2016, in particular Section 5.3 Addressing the debt bias, Section 5.3.4 Debt bias preferred option and Table 12: Assessment of impacts of debt-bias options, as summarised by KPMG's EU Tax Center. See European Commission. Impact Assessment accompanying the document Proposals for a Council Directive on a Common Corporate Tax Base and a Common Consolidated Corporate Tax Base (CC(C)TB). In: *EUR-Lex: Acces to European Union Law* [online]. 25.10.2016 [cit. 2022-06-20]. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52016SC0341&from=EN.

AGI	• approach to profit taxation that does not distort investment and financing decisions • reduced tax planning opportunities (as compared to ACE and ACC) • more level playing field for domestic and multinational companies • lower revenue losses than the ACE • in EC's opinion, Italy's ACE (similar to AGI) has proven quite successful	• as above (ACE cons) • potentially more burdensome from a compliance and administrative costs perspective
ACC	• approach to profit taxation that does not distort investment and financing decisions • achieves full financing choice neutrality (irrespective of the defined notional interest rate)	• no practical experience (no Member State has implemented it so far)

All three options always need to be complemented by anti-avoidance measures. These may include a general denial of deductions when an economic substance is not present, where old equity is "repackaged" as new equity, or if related parties within a group attempt to achieve a repeated deduction for the same amount of capital.

5. A HARMONISED SOLUTION

5.1 DEBRA PROPOSAL

On 11 May 2022, the European Commission published[32] its proposal for the Directive providing for a Debt-Equity Bias Reduction Allowance (DEBRA).[33] This proposal follows up on the work that previously analysed possibilities for reducing excessive incentivisation of debt financing and providing a level playing field for equity and debt, to motivate EU companies to employ more equity funding, thus providing a more stable capital footing for the EU economy. It proposes to allow a deduction for notional interest on equity (or more precisely, on increases to equity). At the same time, the allowance for a deduction of interest on debt financing should be subject to further restrictions. The proposal also introduces special anti-abuse measures to discourage artificial structures designed to benefit from the new allowance.

[32] European Commission. Corporate taxation: Commission proposes tax incentive for equity to help companies grow, become stronger and more resilient. In: *Commission proposes tax incentive for equity* [online]. 11.5.2022 [cit. 2022-06-22]. Available at: https://ec.europa.eu/commission/presscorner/detail/en/IP_22_2884

[33] 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, 2022/0154 (CNS) [online]. 11.5.2022 [cit. 2022-06-22]. Available at: https://ec.europa.eu/taxation_customs/system/files/2022-05/COM_2022_216_1_EN_ACT_part1_v6.pdf.

5.2 NOTIONAL INTEREST ALLOWANCE

The basis for the computation is the difference between net equity at the start and at the end of the tax year. Net equity is the difference between the company's equity and the total tax value of its participations in the capital of associated companies (and its own shares). Equity includes paid-up capital, a share premium, a revaluation reserve, other equity reserves, and retained earnings (profits or losses carried forward).

The calculated increase in the net equity is then multiplied by a reference interest rate. The rate is based on the ten-year risk-free interest rate for a particular currency increased by a risk premium of 1% (1.5% for small and medium-sized companies). The commission will have the authority to modify the level of such a premium.

The result of this computation is a notional interest, which can be deducted in the year of the increase in a company's equity and the following nine tax years. The deduction is subject to an upper limit cap at the level of 30% of the company's earnings before interest, taxation, and depreciation allowance (EBITDA). If this limit is exceeded, the unused allowance can be carried forward to the following five tax years. If the company does not have enough taxable profit in the given year, the carry forward is unlimited in time.

Any additional increase in net equity allows an additional notional interest deduction. On the other hand, a decrease in net equity will result in the taxation of a corresponding amount of notional interest. The proposal provides certain limited exemptions from this rule.

5.3 ANTI-ABUSE MEASURES

The proposal intends to disallow the deduction of notional interest if the increase in net equity results from intra-group loans or intra-group transfers of participations, activities, or cash contributions, unless it can be demonstrated that these transactions have an economic rationale and do not lead to a double deduction. Also, no deduction is generally possible for new equity which has been created by converting old equity (already existing in the group) through reorganisation.

5.4 LIMITATION OF DEDUCTIBILITY OF INTEREST ON DEBT FINANCING

To provide an even more level playing field for equity and debt, and a certain protection of Member State budgets (as otherwise a new equity deduction would clearly result in reduced tax revenues), the proposal intends to introduce a new limitation in the deduction of exceeding borrowing costs, i.e., the difference between interest paid to creditors less interest received from borrowers as defined in ATAD. The interest deduction should be limited to the lower of 85% of the exceeding borrowing costs and the ATAD-based interest allowance. This would typically represent an additional decrease in the interest deduction of 15% compared to the current regime (assuming full deductibility under ATAD rules). The difference between the DEBRA-based limit and the ATAD-based limit would be carried forward to the following tax periods (or back if a carry-back is possible in the particular Member State).

5.5 APPLICATION

The new rules should apply to corporate taxpayers in the Members States and EU-based permanent establishments of companies from third countries. Certain financial institutions will be exempt from the new rules.

The directive should come into effect on 1 January 2024. The Member States that currently apply a notional interest allowance could opt to defer the application of the harmonised rules for up to ten years.

5.6 PROBLEMATIC AREAS

The most important area for the business community will likely be the anti-abuse provisions, their concrete implementation in individual Member States, and above all, their practical application. The direction of travel in terms of providing the new deduction only where economically substantiated is clearly articulated by the proposal, but the impact on real life financing scenarios in business practice remains to be seen.

For foreign investors conducting business activities in a Member State through merely a permanent establishment[34] instead of a subsidiary, the application of the new allowance will depend highly on the level of equity to be considered when applying the new rules. However, permanent establishments normally do not have any formal equity, as there is only one: that of the headquarters, i.e., of the legal entity operating through such a permanent establishment. Part of this equity may effectively be attributable to the business activities performed in the permanent establishment, but its actual value may be difficult to assess. Even if there is a legal structure around a permanent establishment in the form of a registered branch preparing accounts and financial statements including balance sheets based on the requirements of local accounting legislation, the formally reported equity may significantly differ from the equity actually allocated to the business activities of the branch. The proposal clearly confirms the application of the new allowance to permanent establishments operating in EU Member States but provides little insight in how to apply the new rules in terms of the identification of the qualifying equity.

In several areas, the application of the new rules creates an interpretation conflict with the ATAD rules or other technical issues. One of these issues being currently discussed is a proposal for the optional application of the notional interest deduction for equity by a taxpayer, in connection with the application of the corresponding restrictions on the interest deduction on debt financing. Another one relates to the disadvantaging

[34] A permanent establishment is solely a tax concept, which may not have any formal legal status or form in the particular country. The OECD defines it as *"a fixed place of business through which the business of an enterprise is wholly or partly carried on"* (OECD. *Articles of the Model Convention with respect to taxes on income and capital* [online]. Paris: OECD Publishing, 2017 [cit. 2022-06-30]. Available at: https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2017-full-version_g2g972ee-en#page33).

of sectors where debt financing prevails for historical or economic reasons, e.g., aircraft leases, where the very high asset value of the aircraft precludes the quick and massive replacement of debt financing with equity.

The ATAD-DEBRA co-existence and co-application allows for numerous technical discussions. For example, the carry forward of exceeding borrowing costs under ATAD is time-unlimited, but DEBRA provides a time limit in Article 4(1): *"Member states shall ensure that the taxpayers may carry forward, for a maximum of 5 tax periods, the part of the allowance on equity which exceeds 30% of EBITDA in a tax period."*

A conceptual issue of the DEBRA proposal is that it attempts to harmonise the tax treatment of equity and debt among Member States only on the side of the recipients of equity or debt, i.e., from the perspective of a deduction of actual or notional costs for income tax purposes. However, the corresponding tax treatment on the side of the provider of capital or debt remains largely unharmonised. The individual EU States have different approaches to the taxation of interest and dividends received by corporations in their territory. DEBRA will bring a coordinated approach to the deduction of the cost of financing, but its taxation in the hands of the finance providers will continue to be governed primarily by the Member States' tax policies.

6. CONCLUSION

The asymmetry of the tax regime of debt and equity financing has become a major topic of tax policy discussions across EU Member States. The resilience of the economic environment against possible shocks like the recent pandemic or the current energy crisis represents a key argument against the continuation of the incentivisation of debt financing as it may lead to the undercapitalisation of EU businesses.

Therefore, it should be expected that the last initiative resulting in the DEBRA proposal will gain significant support among the Member States, especially if the impact of the new equity allowance on the Member States' tax revenues can be mitigated by a corresponding reduction in the debt financing allowance. The experience of six Member States in the active management of the balance of both these instruments and their tax budgets will certainly contribute to an accelerated discussion about harmonised rules based on the DEBRA proposal. The Czech Republic will likely play an important role in this process as the technical evaluation of feedback on the DEBRA proposal will take place under the Czech EU presidency in the second half of 2022.

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