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Subject:	COMMISSION STAFF WORKING DOCUMENT EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT REPORT Accompanying the document Proposal for a Council Directive on laying down rules on a debt-equity bias reduction and on limiting the deductibility of interest for corporate income tax purposes

Delegations will find attached document SWD(2022) 146 final.

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COMMISSION STAFF WORKING DOCUMENT

EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT REPORT

Accompanying the document

Proposal for a Council Directive

on laying down rules on a debt-equity bias reduction and on limiting the deductibility of interest for corporate income tax purposes

{COM(2022) 216 final} - {SEC(2022) 204 final} - {SWD(2022) 144 final} - {SWD(2022) 145 final}

Executive Summary Sheet
Impact assessment for an initiative to address the debt-equity bias – “DEBRA”
A. Need for action
What is the problem and why is it a problem at EU level?
Tax systems in the EU allow for the deduction of interest payments on debt when calculating the tax base for corporate income tax purposes, while costs related to equity financing, such as dividends, are mostly non-tax deductible. This asymmetry favours the use of debt over equity for financing investments and contributes – alongside other factors such as the preference of existing equity owners to avoid the dilution of control/voting rights, limited access to equity financing, or debt financing being cheaper than equity financing – to an excessive accumulation of debt for non-financial corporations. Excessive debt levels make businesses vulnerable to unforeseen changes in the business environment and increase their risk of insolvency, particularly in times of crisis. Furthermore, the need to incentivise equity investment is now even stronger in view of meetings the demands of the twin digital and green transitions. The scarcity and higher cost of equity affects all companies, but particularly young and innovative businesses, which due to their risk profile, often have limited access to external debt funding and depend on equity investment. Six Member States have been frontrunners in putting in place some form of tax allowance for equity to address the debt-equity bias. However, these national measures can create distortions and a misallocation of investments in the single market if businesses base their decision on the availability or not of an allowance on equity. When applied at national level only, without a harmonised anti-tax avoidance framework at the EU level, these measures can also create loopholes that can be exploited for aggressive tax planning purposes and increase harmful tax competition among Member States.
What should be achieved?
The general objective of the initiative is to address the debt-equity bias consistently throughout the EU and in doing so contribute to the proper functioning of the internal market. More specifically, the initiative aims to achieve the following three objectives: 1. Incentivise equity investment, making the EU economy more stable and resilient. 2. Make equity investment more accessible, particularly to SMEs, young and innovative firms to foster the digital and green transitions. 3. Introduce a common and strong framework of anti-abuse measures to prevent the tax allowance from being abused for aggressive tax planning purposes.
What is the value added of action at the EU level (subsidiarity)?
The problem is the same in all EU Member States, since all EU Member States favour debt over equity in their tax treatment. In addition, a patchwork of actions by six Member States to address the debt-equity bias may have undesirable effects, leading to investment misallocations and leaving open loopholes that can be exploited for harmful tax practices. Within the Union, national approaches risk distorting the internal market and could make some Member States vulnerable to tax arbitrage. Only a common EU framework can make the system simpler and more

efficient for firms while preventing any abuse for tax avoidance purposes.

B. Solutions

What are the various options to achieve the objectives? Is there a preferred option or not? If not, why?

The baseline (option 0) represents the status quo: the difference of tax treatment between equity and debt persists, resulting in a sustained bias towards debt. National measures implemented by Six Member States may distort investment decisions in the internal market. There is no common EU framework to address the debt-equity bias which would mean that the problem persists. Several policy options were therefore considered.

Option 1 would introduce a *tax allowance on the stock of corporate equity*[1]. Profits and losses would be excluded in order to ensure that the allowance is only granted for long-term equity. The duration of the allowance is unlimited.

Option 2 would introduce an *incremental tax allowance of corporate equity* (the same definition of corporate equity as option 1) but in this case granted on the difference in the level of net equity at the end of the tax year compared to the level of net equity at the end of the previous tax year. This allowance would be granted for ten years in order to emulate the average maturity of debt.

Option 3 would envisage an *identical notional interest deduction for debt and equity*. This means a tax allowance on corporate capital (i.e. equity, as per Options 1/2, and debt) while disallowing current deductibility of interest payments. This option perfectly eliminates the debt-equity bias, but has fiscal implications dependent on the level of the notional interest rate chosen. Since the allowance is based on the full stock of capital, the duration of the allowance is unlimited like in Option 1.

Option 4 would completely *disallow the deductibility of interest expenses*. This fully aligns the tax treatment of debt and equity costs by making both non-deductible. Like Option 3, it suppresses the debt-equity bias totally, but at the expense of economic growth and employment. It would also require Member States to renegotiate their Double Tax Treaties and would open up new loopholes for tax planning opportunities. It could also have negative effects in terms of the EU single market's business competitiveness vis-a-vis other jurisdictions, where this deductibility exists.

Option 5 would combine an *incremental tax allowance of corporate equity* (same as proposed under Option 2) with a partial limitation of tax deductibility, which could be obtained by reducing interest deductibility by a given proportion for all companies. It is proposed to limit the deductibility to 85% of the excess borrowing costs (interest paid minus interest received). Like in Option 2, the allowance would be granted for ten years.

Option 5 is the preferred option. It successfully addresses the debt-equity bias, while balancing the budgetary impacts and addressing the fairness aspects of the tax system. It is expected to have a positive impact on investment and GDP, and moderate impacts on employment.

What are different stakeholders' views? Who supports which option?

[1] Equity definition in the sense of this initiative comprises subscribed capital, the share premium accounts, revaluation reserve and reserves.

The majority of business associations and corporations (which represent a majority of respondents) see an EU-wide measure as preferable to country-specific approaches. They think that an allowance for equity would support the economic recovery from the COVID-19 health crisis and help businesses with cross-border activities in the single market. An allowance on equity (Options 1, 2 and 5) is markedly preferred to a disallowance of interest deductions (Option 4) or an identical notional interest deduction for debt and equity alike (Option 3). Some business associations support a special measure for SMEs, because it is more difficult for such businesses to access equity and debt financing, and these respondents to the public consultation stress the importance to design effective anti-abuse measures. Some business associations are opposed to any change in the deductibility of debt. Finally, a financial organisation suggests favouring the allowance on new equity (Option 2 and 5) since it is the only measure that would effectively encourage new investments in equity. An NGO agrees with the problem of the debt-equity bias but cautions on fiscal impacts. According to some citizens, the current low rates of credits and loans do not indicate the need to intervene in this market by reducing the indebtedness of entrepreneurs. An academic considers an EU action for an allowance on equity as problematic, since it does not account for the interaction between the income taxation of corporations and individuals.
C. Impacts of the preferred option
What are the benefits of the preferred option (if any, otherwise of main ones)?
Option 5 provides for a reduction of the debt-equity bias, while preventing a negative impact on Member States' budgets. A limit to the duration of the allowance to 10 years prevents that the measure transforms, over time, into a stock-based allowance and therefore further limits the impact on Member States' public finances compared to Option 1. It will also be less costly than Option 2, since it combines the allowance with a reduction of the tax deductibility of debt-related interest payments. This option, like the others, will provide for a common and strong framework of anti-abuse measures to prevent aggressive tax planning practices at EU level. It will create a level playing field and reinforce financial stability of European private companies, while easing access to the financing market for young and innovative firms.
What are the costs of the preferred option (if any, otherwise of main ones)?
The administrative cost for businesses are negligible or very low. The administrative burden of businesses engaging in cross-border activities would be eased due to the harmonisation of equity allowances across Member States. A decrease of the compliance cost for businesses operating cross-border is expected. Costs for tax administrations would be limited to some additional checks, when auditing tax payers.
What are the impacts on SMEs and competitiveness?
The initiative aims to provide a level playing field throughout the EU. Currently, SMEs can benefit from an allowance on equity only if they are tax residents in one of the six Member States with a national allowance in place, while multinational enterprises (MNEs) can use a subsidiary in one of these Member States to benefit from it. With DEBRA, an allowance on equity will be available in all 27 EU Member States for all businesses, including SMEs and thus provide substantial benefits to them.

In terms of competitiveness, the initiative would decrease the cost of equity and make equity more accessible to SMEs, young and innovative companies, which will boost investments and increase stability of the European financing market, making firms in the European market more stable and resilient to financial crises.
Will there be significant impacts on national budgets and administrations?
The impact assessment shows that the impact for national budgets would be very limited. No impact is expected in terms of control costs for tax administrations with a national allowance for equity already in place. For tax administrations of the other Member States, additional elements will need to be reviewed, but no significant impact is anticipated in terms of workload.
Will there be other significant impacts?
No
Proportionality?
Action would not go beyond what is needed to suppress the debt-equity bias. Taking into account a limitation of interest deduction, it will strongly decrease or even suppress any cost for national budgets, achieving the objective with a limited fiscal impact.
D. Follow up
When will the policy be reviewed?
The Commission will regularly assess the implementation and enforcement of the initiative in the various Member States. Such assessment will be conducted mainly on the basis of data from Member States. Five years after the implementation of the instrument begins, the Commission will evaluate the results of the policy, with respect to its objectives and the overall impacts on tackling the debt-equity bias. In addition the effective application of the anti-tax abuse framework as well as the overall impact on tax revenues, businesses and the internal market will be evaluated.