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DEBRA – potential new tax directive

On 11 May 2022, the European Commission published the first draft of the 'debt-equity bias reduction allowance' directive (DEBRA). The draft proposal is available here.

The Commission claims that the tax systems of many Member States disproportionately favour debt funding by facilitating tax deductions for debt but not for equity funding. The Commission claims that this bias leads to unsustainable debt levels and higher insolvency risks for businesses. There is also a view that a debt-equity bias among European taxpayers may be tax-motivated. In short, DEBRA is designed to encourage greater equity funding and discourage excessive debt funding.

What's proposed?

The Commission proposes two new tax measures as part of DEBRA.

1. The first proposal is to permit an 'allowance on equity' that would provide a tax deduction to taxpayers that increase their equity capital compared to their previous tax year. Broadly, DEBRA proposes that the tax deduction would be calculated by multiplying the amount of increased capital by a 'risk-free' interest rate and a 'risk premium' interest rate. The risk-free rate is a 10-year currency-specific rate calculated under the mechanisms of the Solvency II directive and the risk premium is 1% (or 1.5% for SMEs). This deduction would then be available for 10 consecutive tax years. This 'allowance' is subject to proposed anti-abuse provisions.

2. The second proposal is to refine the existing interest limitation rule (the ILR from ATAD I) so that interest deductibility is potentially further restricted in order to take account of the new allowance on equity (and to further discourage excessive debt). DEBRA proposes to limit the tax deductibility of net interest expenses to the lower of (a) 85% of such expenses, or (b) the amount allowed under the ILR. This is effectively a further limitation on the amount of interest that may be deducted by taxpayers.

In light of the existing ILR, many stakeholders will be surprised to see a further proposal from the European Commission to limit the deductibility of interest expenses. The ILR already provides a robust framework to limit excessive interest deductions and the necessity for a further restriction is questionable. It is likely that this measure will face particular scrutiny during the current feedback period. The majority of EU Member States do not have existing debt-equity bias restrictions in their domestic tax codes.

Who's in scope?

DEBRA is proposed to apply to all taxpayers subject to 'corporate income tax' in EU Member States. A number of exclusions are proposed, including exclusions for AIFs, UCITS, AIFMs, credit institutions, insurance undertakings, certain securitisation entities and other taxpayers. This is not dissimilar to the exclusions available under the ILR.

What's next?

The Commission has a target implementation date of 1 January 2024. The proposal is in draft form and a consultation and feedback period remains open until 12 July 2022. DEBRA will likely develop and mature as stakeholder involvement takes place and it will ultimately require unanimous approval from all Member States. Matheson will be engaging in the feedback process and we welcome client and industry participants approaching us with their views. Please contact the authors below or your usual Matheson tax contact.

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