

News Flash

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**European Commission proposes
Directive on DEBRA (debt-equity
bias reduction allowance)**

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On 11 May 2022, the European Commission issued a Proposal for a Directive on laying down rules on a debt-equity bias reduction allowance and on limiting the deductibility of interest for corporate income tax purposes (DEBRA) (COM/2022/216 final). This proposal follows up the Communication on Business Taxation for the 21st century (COM(2021) 251 final), which was adopted by the European Commission on 18 May 2021 and which we informed you about in our Flash News [here](#).

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 in tax treatment is one of the factors favouring the use of debt over equity for financing investments.

With a view to addressing the tax-induced debt-equity bias across the single market in a coordinated way, this directive proposal lays down rules to provide, under certain conditions, **for the deductibility for tax purposes of notional interest on increases in equity and to limit the tax deductibility of exceeding borrowing costs**. These rules should apply to all taxpayers that are subject to corporate tax in one or more Member State, except for financial undertakings. Since small and medium enterprises (SMEs) usually face a higher burden to obtain financing, it is proposed to grant a higher notional interest rate to SMEs.

In the light of the different objectives between this proposal and the ATAD rule on interest limitation, the two rules on limiting the deductibility of interest should apply in parallel.

If this proposal is adopted as a Directive, it should be transposed into Member States' national law by 31 December 2023 and come into effect as of **1 January 2024**.

Below we summarize in brief the key information on two measures covered by the proposal.

Allowance on equity

Under the proposal, the allowance on equity is computed by multiplying the allowance base with the relevant notional interest rate (NIR).

The allowance base is calculated as the difference between the level of net equity at the end of the tax period and the level of net equity at the end of the previous tax period. The relevant **NIR** is based on two components: the risk-free interest rate and a risk premium.

The risk-free interest rate is the risk-free interest rate with a maturity of ten years, as laid down in the implementing acts to Article 77e(2) of Directive 2009/138/EC, in which the allowance is claimed, for the currency of the taxpayer. Risk Premium is set at 1% (or 1.5% for SMEs).

An allowance on equity is deductible, for **10 consecutive tax periods**, from the taxable base of a taxpayer for corporate income tax purposes up to 30% of the taxpayer's EBITDA. If the deductible allowance on equity is higher than the taxpayer's net taxable income, the taxpayer may carry forward the excess of the allowance on equity without a time limitation. Taxpayers will also be able to carry forward their unused allowance on equity which exceeds the 30% of taxable income for a maximum period of **5 tax years**.

Anti-abuse provisions

The base of the allowance on equity does not include the amount of any increase which is the result of:

- granting of intra-group loans;
- intra-group transfers of participations or of a business activity as a going concern; and
- 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.

However, this is not applicable if the taxpayer provides sufficient evidence that the relevant transaction has been carried out for valid commercial reasons and does not lead to a double deduction of the defined allowance on equity.

Other measures set specific conditions for equity increase from contributions in kind and target the re-categorisation of old capital as a new capital.

Limitation to interest deduction

The proposal **also introduces a reduction of debt interest deductibility by 15%**, to better mitigate the debt-equity bias. In particular, a proportional restriction will limit the deductibility of interest to 85% of exceeding borrowing costs (i.e. interest paid minus interest received).

Given that interest limitation rules already apply in the EU under Article 4 of the ATAD, **the taxpayer will apply the rule of Article 6 of this proposal as a first step and then, calculate the limitation applicable in accordance with article 4 of ATAD.** If the result of applying the ATAD rule is a lower deductible amount, the taxpayer will be entitled to carry forward or back the difference in accordance with Article 4 of ATAD.

By way of example, if company A has exceeding borrowing costs of 100, it should:

1. First, apply Article 6 of this directive proposal that limits the deductibility to 85% of 100 = 85 and thus renders a non-deductible amount of 15.
2. Second, compute the amount that would be deductible under Article 4 of the ATAD. If the deductible amount is lower, e.g. 80 (and subsequently the non-deductible higher, i.e. 20), the difference in the deductibility, i.e. the additional non-deductible amount (i.e. $85 - 80 = 5$) would be carried forward or back in accordance with the conditions of Article 4 of ATAD, as transposed in national law.

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Contact

Katarína Balogová

Tax Director

E-Mail: Katarina.Balogova@accace.com

Tel: +421 2 325 53 000



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