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URL: http://www.deloitte-tax-news.de/german-tax-legal-news/independent-advisory-board-to-the-mof-issues-statement-raising-concerns-over-eu-debt-equity-bias-proposal.html

25.08.2023

German Tax and Legal News

Independent Advisory Board to the MOF issues statement raising concerns over EU debt-equity bias proposal

Statement supports the goal of reducing debt financing but criticizes the means described in the draft directive

On 17 August 2023, the German Ministry of Finance (MOF) published a statement of its Independent Advisory Board (Wissenschaftlicher Beirat) dated 11 July 2023 regarding the draft EU directive on debt-equity bias reduction allowance (DEBRA) rules and limiting the deductibility of interest for corporate income tax purposes. In the 12-page statement, the Independent Advisory Board agrees with the goals of the draft EU directive to strengthen the equity financing of companies and to reduce incentives for debt financing but does not see the approach chosen by the draft EU directive as a viable path to achieve these goals.

The Independent Advisory Board advises the MOF by regularly publishing expert opinions and reports on current issues. It is an expert body consisting of 31 academics (not just tax academics) that has existed for more than 70 years. Its opinions and reports are informal in character and non-binding on the government.

Background
The draft EU directive was published on 11 May 2022, and the European Council stated in December 2022 that discussions about this proposal would be temporarily suspended and reassessed at a later stage in the broader context of other upcoming reforms in the area of corporate taxation (e.g., the Business in Europe: Framework for Income Taxation initiative).

Under existing tax rules, businesses in EU member states generally may deduct interest attached to debt financing, but not the costs related to equity financing. This asymmetry in the tax treatment of debt and equity financing across the EU induces a bias towards debt in investment decisions based on the view of the European Commission. In order to address this bias, the draft EU directive includes a two-fold approach. First, it proposes an allowance on equity by providing for the tax deductibility of notional interest on increases in net equity. The deductible amount would be computed by multiplying the allowance base by the applicable notional interest rate. The allowance on equity would be granted for 10 years, i.e., it would be deductible in the year it was incurred and in the following nine years. To prevent tax abuse, the deductibility of the allowance for each tax year would be limited to a maximum of 30% of the taxpayer’s earnings before interest, taxes, depreciation, and amortization (EBITDA). Second, the allowance on equity would be accompanied on the debt side by a rule limiting the deductibility of interest. This rule would limit the deductibility of interest to 85% of the taxpayer’s excess borrowing costs, i.e., the excess of interest paid over interest received. The European Commission has indicated that the interest deduction limitation rules based on Council Directive (EU) 2016/1164 (the Anti-Tax Avoidance Directive or “ATAD 1”), which is a 30% EBITDA limitation, would apply in parallel with the interest deduction limitation rule in the draft EU directive.

Independent Advisory Board statement summary
The main concerns of the Independent Advisory Board described in the statement are summarized as follows:

- Tax incentives for debt financing would be reduced but the asymmetry in tax treatment of debt and equity financing and the resulting bias towards debt in investment decisions would not be removed.
- The proposed rules would only be applicable to corporate taxpayers but not to partnerships, which would have significant impact for certain tax regimes in EU member states.
- The proposed rules would result in a limitation of EU member states’ sovereignty, and the proposed directive would be outside of EU competency. This, in particular, applies to the proposed additional limitation on the deductibility of interest expense, since this feature is not required for the establishment and functioning of the internal market. A loss of revenue resulting from the application of the proposed notional

interest deduction could be compensated for by raising tax rates. It is exclusively within the competency of the national legislators of the EU member states to decide on the appropriate compensation for a loss in domestic tax revenue.

- The required intervention into the domestic tax regimes of the EU member states cannot be justified with the establishment and functioning of the internal market.
- The proposed rules would potentially result in inconsistent tax treatment in connection with the interest deduction limitation rules of ATAD 1.
- The interaction between the proposed rules and the EU Pillar Two directive on ensuring a global minimum level of taxation for multinational enterprise groups would need to be analyzed in more detail.
- The proposed additional limitation on interest deductibility would violate the principle of taxation based on economic performance ("objective net principle"). The proposed additional limitation would not make tax avoidance by multinational enterprise groups more difficult but would simply be introduced for balancing a reduced budget resulting from the introduction of the notional interest deduction regime. As a result, the proposed additional limitation mostly would affect small and medium-sized companies that use debt financing primarily for financing purposes and not for tax planning purposes.

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