STATEMENT

FEEDBACK ON THE PROPOSAL FOR A DIRECTIVE ON DEBT-EQUITY BIAS REDUCTION ALLOWANCE (DEBRA)

Luxembourg, 1st August 2022

LuxCMA feedback on the European Commission's proposal for a Directive on Debt-equity bias reduction allowance (DEBRA)

The Luxembourg Capital Markets Association (**LuxCMA**) welcomes the opportunity to respond to the European Commission's feedback request on the suggested "Debt-equity bias reduction allowance (DEBRA)" and is pleased to hereby provide comments on the Proposal for a Directive published on 11 May 2022 ("the Proposal").[1]

LuxCMA represents the common interests of the stakeholders of the primary capital markets industry of Luxembourg. Constituted as a not-for-profit association, its mission is to promote Luxembourg's capital markets, provide networking and collaboration opportunities and foster innovation in the industry. LuxCMA's goal is to become the single point of contact for authorities, associations, market practitioners and other actors in Luxembourg. Our members comprise pan-EU and global banks as well law firms, investors, and other financial market participants.

While we support the stated aim of the initiative to mitigate the debt-equity bias induced by taxation in principle, and acknowledge that equity investment should be promoted, we believe any such initiative must be carefully considered to not negatively impact the competitiveness of EU capital markets. We agree that there is a need to improve companies' "resilience to unforeseen changes in the business environment and decrease the risk of insolvency." However, precisely as a result of agreement with this aim, we believe that bankruptcy-remote vehicles and vehicles that are not at risk of adjusting their debt-equity structure for tax reasons, such as securitization vehicles, need to be excluded from the scope of the Proposal.

[1] 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

Moreover, we have doubts that the Proposal would effectively achieve the stated objective as a result of several technical elements.

We also believe that for many taxpayers the Proposal will result in an additional tax burden. Member States' tax administrations and taxpayers have had to implement and adapt to a significant number of Directives in the field of direct taxes in recent years that have resulted in broadening tax bases. This pace and the complexity of the Directives, as well as lack of harmonized implementation and application, put significant strain on both tax administrations and taxpayers. Contrary to the statements in the impact assessment we believe that the Proposal entails significant administrative burdens for taxpayers, while the burden of dealing with existing (and very limited) systems of deductions on equity is overstated. We therefore disagree on the statement that the Proposal is proportional. Prior to adding another Directive on top of the already significant administrative burden of EU companies created in recent years, we believe it would be more appropriate for the Commission to focus on achieving a more harmonized application of already existing Directives.

These points are further developed in the appendix to this statement.

APPENDIX

TECHNICAL COMMENTS ON THE PROPOSAL FOR A DIRECTIVE ON DEBT-EQUITY BIAS REDUCTION ALLOWANCE (DEBRA)

LuxCMA Technical comments on the European Commission's proposal for a Directive on Debt-equity bias reduction allowance (DEBRA)

1. Need to exclude low-risk companies

It should be highlighted that the choice between equity and debt financing is not based solely on tax considerations. The decision whether to issue debt or equity instruments to third party investors is not driven by tax considerations but considers a range of criteria. When deciding whether to make an investment in a debt or equity instrument investors factor in various elements, including the capitalization of the issuer and whether it has the capacity to service its debt. As a result, in the case of unrelated investors there should be no risk of tax avoidance practices in respect of debt financing, the prevention of which is also an objective according to the Initial Impact Assessment.

We agree that there is a need to improve companies' "resilience to unforeseen changes in the business environment and decrease the risk of insolvency." Investors on EU Capital Markets are familiar with bankruptcy-remote vehicles, such as securitization vehicles. However, precisely as a result of agreement with this aim, we believe that bankruptcy-remote vehicles and vehicles that are not at risk of adjusting their debt-equity structure for tax reasons, whether EU or domestic, such as securitization vehicles, need to be excluded from the scope of the Proposal. At the very least, EU Member State shall be given flexibility with respect to the possible exclusion of domestic financial undertakings that are bankruptcy remote.

Alternatively, rather than imposing such allowance on equity on all taxpayers (which in our view does not achieve, in the current reading of the Proposal, the primary aim to put debt and equity financing on equal footing) taxpayers should be given the choice to apply the deductible allowance.

2. Failure to mitigate the debt-equity bias induced by taxation

In our view the suggested deductible allowance on equity is unable to eliminate the asymmetry in tax treatment of equity versus debt financing. To achieve an alignment of the tax treatment of both financing methods the following items would have to be considered:

- Interest is computed on the full amount of debt, while the deductible allowance on equity will only apply to increases in a taxpayer's equity from one tax period to the next. Moreover, interest (and the resulting deductions) apply throughout the entire amount the financing is in place, and not only for a 10-year period.
- The rate to be applied to the basis for the allowance, as foreseen in the Proposal, is very low and certainly not comparable with the interest rate that would apply to debt financing.

Both elements seem contradictory to the statement in the Impact Assessment Report according to which "this initiative supports the creation of a harmonized tax environment that places debt and equity financing on equal footing across the EU." The suggested measure therefore falls short of achieving its stated aim and at the same time introduces additional restrictions on the deductibility of interest deductions that go beyond the interest limitation rules introduced by 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 (ATAD).

In order to really eliminate the tax-induced bias against equity, the full amount of equity should be entitled to a deduction that is similar to that on debt financing. This could be achieved by (i) extending the basis for the allowance to the full amount of equity (ii) applying the deduction for as long as the full time the equity exists and (iii) applying a comparable rate as applies to debt financing. Various methods could be envisaged to determine the rate such as referring to the average interest rate applicable to long-term financing of the taxpayer or determining an arm's length rate on long-term subordinated financing through the application of transfer pricing (taking into account the specificities of a given taxpayer, its risk profile, the sector it operates in, etc. as if the equity financing was debt).

3. Additional restrictions on the deductibility of interest deductions

Current EU legislation, as transposed by the various Member States in their domestic legislation, already provides for numerous rules to combat excessive and tax-driven use of debt financing. As a result, we do not believe that an additional restriction is necessary or proportional. Moreover, it appears that the restriction on deductibility of interest would also apply to interest on loans that were concluded before 17 June 2016 and that benefit from grandfathering according to ATAD. This would mean that the Proposal takes back a right that has been given to taxpayers without providing for a new equivalent right. At the same time, the new allowance for equity is limited to additional equity and is expected to be very low. Such additional restriction, in our view, runs counter to the ability-to-pay principle, which is a fundamental principle underlying Member States' income tax system. An increase in income tax burden is in our view not conducive to building "*a fully functioning and integrated market for capital, allowing the EU's economy to grow in a sustainable way and be more competitive as set out in the 2020 Communication on a Capital Markets Union.*" Considering the above, while we understand that the deduction allowance in respect of equity should not result in additional deductions on top of the exceeding borrowing costs that are deductible under ATAD, the Draft Directive should not restrict existing deduction rights so that any deduction of interest that is currently allowed under ATAD remains available. If any additional restrictions on the deductibility of interest deductions are introduced at all, they should be limited to additional debt contracted on or after the effective date of the Proposal.

In addition, due to the absence of a risk of avoidance, companies that have a transferable security admitted to trading or listed on a regulated market or multilateral trading facility as defined under Directive 2014/65/EU of the European Parliament and of the Council) should be excluded from the additional restrictions on interest deduction that we understand was included in the Proposal as an anti-abuse measure.[2] Finally, should the suggestion provided above to fully exclude bankruptcy remote vehicles from the scope of the Directive not be applied, these should at least be excluded from the additional restrictions on interest deductibility as they are typically not using equity as a source of funding.

[2] Similar to the exclusion included in the Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes (ATAD 3).

4. Additional compliance burden

The proposed measures are quite restrictive and complex. Features such as applying the allowance only to increases in a taxpayer's equity from one tax period to the next, limiting its application to 10 years and foreseeing complex and restrictive anti-abuse rules are, on the one hand, discouraging to investors and, on the other hand, burdensome to manage for tax administrations and taxpayers alike as a result of e.g., the tracing of equity and intragroup transactions. We believe that the issues as a result of the absence of community action are overstated and do not outweigh the significant additional compliance burden that would arise to taxpayers and tax administrations if this Proposal was implemented. We can therefore not share the view expressed in the Impact Assessment Report that "*[the costs] are expected to be negligible or very low because the number of information items to be transmitted is limited and the points needed are all already collected for other purposes*."

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ABOUT US

The Luxembourg Capital Markets Association (**LuxCMA**) represents the common interests of the stakeholders of the primary capital markets industry of Luxembourg. Constituted as a not-for-profit association, its mission is to promote Luxembourg's capital markets, provide networking and collaboration opportunities and foster innovation in the industry. LuxCMA's goal is to become the single point of contact for authorities, associations, market practitioners and other actors in Luxembourg. Our members comprise pan-EU and global banks as well law firms, investors, and other financial market participants.

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