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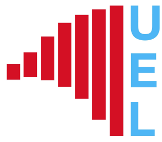

EU directive proposal on laying down rules on a debt-equity bias reduction allowance and on limiting the deductibility of interest for corporate income tax purposes

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UEL response to the EU public consultation

The EU Commission released in May 2022 a proposal for a Directive (hereafter the "EU Proposal") on laying down rules on a debt-equity bias reduction allowance (hereafter the "Equity allowance") and on limiting the deductibility of interest for corporate income tax purposes (hereafter the "New interest deduction limitation rule").

UEL and the Luxembourg business sectors it represents, support the EU Commission's long-term vision to provide a fair and sustainable business environment and EU Tax system as set out in its Communication on Business Taxation for the 21st Century. As part of this long-term vision, we support the objective to address the debt-equity bias by removing taxation as a factor that can influence companies' funding decisions.

However, the key to making this reform successful is to strike the right balance between increased tax allowances on equity vs. limiting interest deductions. Overly restricting interest deductions goes against the overarching policy objective and would disproportionately impact companies that have more difficulties accessing equity markets, such as SME's.

We therefore believe that the EU Proposal must be amended to ensure on one hand, that the Equity allowance is made more effective and, on the other hand, that it does not further restrict interest deductions.

In our view, the following key considerations are critical to further improve the legislation to ensure that it meets its objectives while remaining in accordance with EU constitutional principles, notably proportionality and equal treatment.

General comments on the EU Proposal

Whilst we support the idea of allowing companies deductions in relation to equity financing, we do not support the idea of restricting interest deductions on debt further, when there are already interest deduction limitation rules in place across EU countries following the implementation of the EU ATAD 1.

Besides, we are concerned that the current EU Proposal would be detrimental to the objective of addressing the debt-equity bias, as it could create unintended distortive situations such as the following ones:

(i) for those Member States (hereafter "MS") which will have to implement the New interest limitation rule as from 2024 while MS with existing equity allowance/notional interest deductions would benefit from a 10-year grandfathering period; and

(ii) for those taxpayers who might be negatively impacted by the EU Proposal if they are not in a position to benefit from the Equity allowance but are nevertheless subject to the New interest deduction limitation rule.

Furthermore, we fear that the introduction of a New interest deduction limitation rule will go beyond ensuring the minimum necessary level of protection for the internal market and would be in contradiction with the proportionality principle (when paired with the ATAD rules in place to manage interest limitations following BEPS).

In this respect, we believe that the objective pursued by the EU Commission in support of the introduction of such a restriction must be further clarified Indeed, it is explicitly stated in the EU Proposal that the New interest deduction limitation rule aim at ensuring "*the sustainability of the measures for Member States' budgets by virtue of a general rule that limits the deductibility of financing costs from taxpayers' taxable base*". However, it is also mentioned that "*While the fight against tax avoidance is not its predominant purpose, this proposal also includes an interest limitation rule. In 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*". Besides, we understand different policy options have initially been considered by the EU Commission. Consequently, other alternatives, and in particular an equity allowance without further interest deduction limitation, could still validly be considered[1].

If it is confirmed that the main reason lies in the protection of MS tax revenues, we stress that it should rather be left to each MS to determine how a possible financing of this Equity allowance should be made (after having conducted on an assessment on the expected impact on their respective national budget). Another solution would be to either leave the implementation of the Equity allowance optional at MS' level or leave the regime optional for taxpayers. Adding the optionality to the EU Proposal would give flexibility for MS to implement this initiative while ensuring they can adapt it to the specificities of their domestic market, their respective policy objectives and constraints in terms of tax revenues.

Besides, we would like to stress that this New interest deduction limitation rule appears overburdening where the debt is in place for genuine commercial reasons in line with the EU General Anti-Abuse Rules (GAAR). It should be recalled that debt provides companies with greater flexibility to move cash within the group and quickly adjust working capital depending on business cycles and seasonal aspect of business activity, which are not consistent across the year. The decision to raise debt is thus often made based on genuine commercial reasons.

Equity, in contrast, is difficult to quickly adjust for liquidity needs, and there are often legal, accounting, and other hurdles to return equity to shareholders. For example, in several countries it is only possible to legally distribute equity within distributable reserves limits and there is often a requirement to have recently audited statutory financial statements before a dividend can be distributed. This creates a materially greater burden than debt, for example through the creation of interim financial statements exclusively to that purpose. Therefore, equity may be a more unattractive option for pure treasury and cash flow purposes.

Most companies use a mix of debt and equity responsibly and keep debt levels within sufficiently low debt/equity ratios in line with the current EU GAAR and transfer pricing requirements.

Finally, the introduction of New interest deduction limitation rule could jeopardize the current international level playing field existing based on the BEPS provisions (which apply in non-EU countries,

[1] See Commission staff working document (11.05.2022, SWD(2022) 145 final), Impact assessment report, section 6 « what are the impact of the policy options ») (pages 37 onwards).

and for example in the US) and their EU equivalent (e.g., the interest deduction limitation of the ATAD 1) which would trigger a loss of competitiveness for MS.

Specific comments on the EU Proposal

- *Equity allowance*

We regret that the introduction of the Equity allowance has not been anticipated and properly addressed in the EU proposal of Directive on ensuring a global minimum level of taxation for multinational groups in the Union (i.e., Pillar 2 rules) to mitigate any adverse tax consequences on taxpayers' effective tax rate computation for Pillar 2 purposes.

Besides, we fear that the conditions and anti-abuse rules set for taxpayers to benefit from the Equity allowance are such that the EU Proposal may not reach its objective of effectively encouraging equity financing.

We therefore stress that the Equity allowance should be amended and redesigned on a certain number of key points, notably on the following points:

- The term "equity" is defined by reference to Directive 2013/34/EU (Accounting Directive). However, Private Equity and Venture Capital players (which play an important role in SME financing) often provide quasi-equity financing, which in certain instances result in debt accounting treatment compared to equity tax treatment (e.g., certain preference shares, equity certificates, etc.). Consideration should be given to extend the definition of equity to instruments treated as equity for tax purposes (and not only for accounting purposes) to ensure legal certainty.
- Clarity should also be given in the EU Proposal as to the treatment of the Equity allowance at the level of the shareholders in order to increase legal certainty for taxpayers and avoid diverging tax treatments between MS.
- The reference interest rate might appear to be too low to act as an effective incentive for taxpayers to increase their equity financing. Therefore, we believe that taxpayer should have the option to choose to apply the higher of the reference rate or an arm's length rate (to the extent that it is duly documented). The effectiveness of the measure could also be increased by allowing MS to enlarge the scope of the Equity allowance to existing equity (possibly on an optional basis depending on the expected impact of such enlargement on their tax revenues).
- The Equity allowance requires tracing of equity and intragroup debt balances over several years, as well as annual losses and changes because of restructuring and reorganizations. This would create a considerable compliance burden to calculate the additions and subtractions to equity for every entity that is subject to these rules. We would welcome simplifications in this area and the removal of tracing requirements.
- The Equity allowance is limited to 30% EBITDA, and there are also interest limitation rules in place following ATAD 1 that are EBITDA-based. It would be helpful to confirm that these are two separate tests, and that the Equity allowance does not need to be aggregated with interest expenses on debt for the purposes of applying these rules. To simplify compliance requirements for groups, we would strongly recommend that the basis for the 30% EBITDA test for the Equity allowance is very simple (e.g., 30% of EBITDA per local GAAP financial statements or ATAD 1 EBITDA computation). Having different calculation methods for different countries (as is already the case today for ATAD 1 rules that are in place) would be unduly complex and burdensome.
- The wording of the EU Proposal suggests that the proposed measures are mandatorily applicable for all taxpayers. As noted above, there could be different drivers behind the choice of equity vs. debt financing (and tax could be only one of them). Therefore, in addition to the

above, consideration should be given to make the application of the rules optional or elective for taxpayers to limit compliance burden for taxpayers that do not wish to avail such measure. The optionality could give flexibility and avoid cumbersome compliance obligations for such taxpayers.
- More generally, we are calling for additional definitions and clarifications of the various anti-abuse rules which are currently foreseen to ensure a smooth and consistent application by all Member States, as well as to increase legal certainty for taxpayers.

- *New interest deduction limitation rules*

As mentioned above, we call on the EU Commission to reconsider the introduction of this rule, unless it is demonstrated what is the exact objective pursued and that the introduction of such rule is absolutely required and proportionate to reach this goal. In this context, we would like to stress that the Common Corporate Tax Base (CCTB) Proposal previously issued by the EU Commission provided for an equity allowance together with an interest deduction limitation rule, but this later rule was similar to the current provision of ATAD 1 without further additional limitation.

Should the EU Commission nevertheless consider that a New interest deduction limitation rule is required, we stress that:
- The scope of the Equity allowance and of the interest deduction limitation rules of the ATAD 1 should be fully aligned. This would notably imply to exclude the 'securitisation special purpose entity' as defined in Article 2, point (2), of Regulation (EU) No 2017/2402 of the European Parliament and of the Council, from the interest deduction limitation rules of the ATAD 1. More generally, all current carve-outs and escape clauses of the ATAD 1[2] should also be applicable to taxpayers falling within the scope of the New interest deduction limitation rule (i.e., clarification that the same exceeding borrowing cost and the same exceptions should apply under both rule sets). This could help to retain consistency and legal certainty across the various interest limitation rules and avoid cumbersome complications / computations.
- More explanations should be given on the interactions between the Equity allowance and the New interest deduction limitation rules to increase legal certainty for taxpayers and avoid possible diverging interpretations by MS (for instance, no application of the New interest deduction limitation if no Equity allowance is applied).
- The EU Proposal should clarify that non-deductible exceeding borrowing costs under the New interest deduction limitation rule should follow the same treatment as under ATAD 1 (i.e. such non-deductible interest expenses may be carried forward without time limitation).
- In addition, it should be further elaborated on what are the economic rationale behind the introduction of the 85% limitation of the tax deductibility of exceeding borrowing costs. The 85% limitation could lead to additional tax burden to taxpayers where they are not in the position to avail the Equity allowance. Further consideration should be given that instead of the 85% limitation, the deductible exceeding borrowing cost under ATAD I would be reduced by the equity allowance deducted in the tax year. This could ensure that (1) taxpayers are not penalized by the additional interest limitation if they are not able to take advantage of the equity allowance (as in that case there is no need to compensate the MS' budget for lost tax revenue), and (2) also ensure flexibility of the rules in case the use of allowance on equity would be optional / elective.
- The further restrictions on interest deductibility on debt do not appear to consider whether debt is third party or intragroup. This does not seem proportionate, given that third party debt

[2] See the list of (i) carve-outs: EUR 3 million safe harbor rule, standalone entities, grandfathering and long-term public infrastructure projects, and (ii) escape clauses: "equity/total assets" ratio test and group EBITDA" test

should already be on arm's length terms, and therefore deductibility should not be restricted for interest on third party debt.

- In many EU countries, for local GAAP purposes, expenses on finance leases are treated as 'interest' (in contrast to operating leases where expenses are treated as 'other operating expenses'). We would recommend that the rules on interest deductibility for debt exclude leases as this could be a barrier for taxpayers to enter into standard business/commercial arrangements.
- Simplifications measures should be foreseen to avoid triggering significant additional compliance costs for taxpayers who will otherwise have to perform additional computations, trackings and reportings in parallel to the ATAD 1 interest deduction limitation rules.
- Finally, the date of entry into force of the New interest deduction limitation rule should be the same in all MS, irrespective of whether they will apply the Equity allowance or rely on an existing similar domestic tax regime.

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About UEL:

UEL (Union des Entreprises Luxembourgeoises) is the Luxembourg Employers' Association. UEL represents the Luxembourg private-sector businesses, except for the primary sector, and includes the Grand Duchy's professional chambers and employer federations.

UEL works for a sustainable and prosperous economy for Luxembourg, its inhabitants and those who work there. It endeavors to provide an economy that is attractive to both investors and talented individuals.

To accomplish its mission, UEL facilitates working groups and discussions with its member organizations on major inter-branch topics. It is thereby able to present joint positions to the public authorities and social partners on these topics which they can then review together.

The initiatives launched by UEL are based on the values of the social market economy, sustainable development, business ethics, good governance and dialogue.